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Economic Council of Canada

Volume 7, No. 1

Health care for the elderly



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Research studies are published by the Economic Council in both official languages. A list of titles is available on request. Each study clearly attributes the findings and conclusions to the individual author or authors rather than to the Council (ordering information below). One new title has been published since the last issue of *Au Courant*.

Forest Management and Economic Growth in British Columbia, by *Michael B. Percy* (EC22-130/1986E; $7.95 in Canada, $9.55 elsewhere).

Colloquium Proceedings

The Council's two-day Colloquium on the Environment pinpointed some of the major environmental problems facing Canada and other countries. It brought together more than 100 experts from diverse backgrounds in scientific research, economics, environmental management, public administration, and industry. A summary of the Colloquium proceedings was featured in *Au Courant* (vol. 6, no. 3). The papers presented at the Colloquium have also been collected in a volume of proceedings, which can be ordered in accordance with the information below.

Managing the Legacy: Proceedings of a Colloquium on the Environment, December 1985 (EC22-131/1986E; $9.95 in Canada, $11.95 elsewhere).

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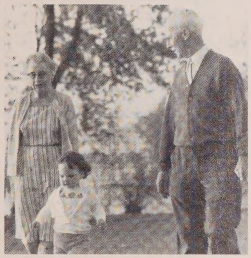
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Editor: *Barbara S. Campbell*

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Aging with limited health resources

Will Canada be able to meet the needs of its aging population by the turn of the century? Rising health care costs, combined with an anticipated wave of senior citizens as the baby boomers grow old, have made this question a critical one for policy-makers. With that in mind, the Economic Council sponsored a Colloquium on "Aging with Limited Health Resources," which was held in Winnipeg in May. Participating with the Council in this event were the Canadian Hospital Association, the Canadian Medical Association, the Canadian Nurses' Association, and Health and Welfare Canada.

Over a two-day period some 100 participants from diverse backgrounds in scientific and social research, economics, health administration, and government talked about the key issues in the health care field and explored potential developments. The highlights of their discussions are presented on the following pages.

The international perspective

By world standards, Canada has a first-class health care system. Access is virtually universal (and prompt to boot); facilities are widely available; the quality of care is good; costs are reasonable; and techniques, up-to-date.

But Canadians themselves tend to be critical of their system, with many calling for major reforms, observed professor William Glaser, from the Graduate School of Management and Urban Professions in New York, in the Colloquium's lead-off presentation.

Glaser's analysis of Canada's health care problems suggests that some, at least, "are much smaller than Canadians think." For example, the issue of cost control is not as serious in this country as in many others, illustrated by the fact that, over the past two decades, health costs here have not increased as much, as a proportion of Gross Domestic Product, as they have elsewhere. In fact, Glaser said, Canada has become a model for other countries in this regard, primarily because of its use of payment methods (such as funding hospitals from "global" – or one-source – budgets) that effectively control costs. Canada has also acted more decisively than some other nations in curbing too-rapid expansion in its medical profession; and it has been quite successful in developing alternative health service facilities such as day care, home care, and ambulatory centres to take the pressure off hospitals.

As is everywhere the case, Canada will have to come to grips with the dilemma of providing care for its elderly, Glaser noted, adding that the problem is less acute in this country since it has fewer old people than any other developed nation. Nevertheless, critical questions of financing long-term care and of creating and managing services to meet the needs of senior citizens will have to be dealt with in Canada, as elsewhere.

Should Canada be making fundamental changes to its health system? Not in world opinion, Glaser concluded. Critics who argue for major reforms – such as privatization, a more consumer-oriented system, the reorganization of medical practice, or a revised system of payments – are not, in his view, on very solid ground.

Discussant Robert Kane, dean of the School of Public Health at Minnesota University, commented that "to the American observer, the Canadian

health care system seems marvellously civilized" and "surprisingly free of litigation and regulation."

He cautioned against adopting the "capitation" system (whereby health organizations provide health care to individuals in return for a regular fee), which is currently catching fire in the United States. That system "makes money on those who use it little," he remarked, "while those who make heavy demands represent losses."

At the same time, he raised several questions about Canada's method of paying hospitals from global budgets – an approach that contrasts with the multifaceted, fragmented U.S. system. The Canadian approach, he noted, would appear to deprive hospitals of the incentive to keep patient stays at a minimum.

In conclusion, he praised Canada's extension of universal health care coverage to include long-term care. He observed, however, that this country, along with its neighbour to the south, must solve the problem of co-ordinating long-term care with acute care. At present, these two areas are managed separately, causing duplication and inefficiency.

Discussant Betty Havens, provincial gerontologist at the Manitoba Department of Health, pointed to some immediate and long-term concerns in the health area. An important issue has to do with providing health care – particularly long-term care – to an aging population, she said, noting that today's elderly receive 80 per cent of their care from the informal support network of family, friends, and neighbours. She stressed the need to link this informal structure with the formal system, ideally under the management of a "case co-ordinator." This arrangement works well in Manitoba, she observed, where program nurses or social workers act in that capacity.

Havens also discussed the issue of women and health care. She noted that women predominate as both givers and receivers: they consume health services at rates disproportionate to their numbers; and they are the principal caregivers in both the formal and informal systems. They will need greater support in both these roles, she warned.

Floor discussion

A number of questions and comments were aired in the ensuing floor discussion. One participant observed that health care has become an industry in its own right, employing large numbers of workers. Glaser concurred, pointing out that meeting the wage demands of hospital employees accounts for a large slice of mounting hospital costs.

The need to link long-term and acute (or hospital) care also concerned participants. One suggested that medical and nursing schools should stress the importance of this linkage in their programs. Kane queried whether a medically centred system was the answer, saying that he preferred a "social model."

Meeting health care needs

An interweaving of formal and informal care networks is probably the most efficient and least costly method of meeting the needs of the elderly, said Alan Walker, professor of social policy at the University of Sheffield, England.

There are dangers to relying solely on the community for health care services, he continued. For one thing, community care, by and large, means family care, which in turn means care by female family members – a situation that is unlikely to continue indefinitely, particularly in light of increasing numbers of old people. Furthermore, there is always the risk that politicians and officials will ask too much of the informal system, both in terms of services and as a means of reducing health care costs.

At the same time, institutions (hospitals and old-age homes) shouldn't be overused either – particularly since the majority of old people need social rather than medical attention. Canada tends to err in this direction, Walker observed: compared with Britain, where 5 per cent of residents over the age of 65 are institutionalized, 9.5 per cent are in institutions in this country. One explanation is that "powerful medical and nursing interests" favour the institutional route, he noted.

Walker advocated the development of non-institutional, community-based policies, using a combination of formal and informal support systems. As an example of how this approach can work, he pointed to projects in Britain and in Nova Scotia, where families are paid to look after relatives who would otherwise be institutionalized. Other schemes have provided care to the elderly in their homes at no extra cost through a system of visiting wardens, emergency telephone services, home-care assistants, and so forth.

The main lesson to be learned from British attempts to implement this kind of policy over the past 30 years, he concluded, is "not to underestimate the strength of the forces opposed" and "not to overestimate the caring capacity of the community."

A two-pronged strategy to control health care costs and to wipe out disabling disease may help solve Canada's long-term health care problems, said discussant Kenneth Manton, a professor of both demographic studies and medical research at North Carolina's Duke University.

He observed that growth in the numbers of old people, along with a probable increase in life expectancy, will inevitably lead to greater demand for health care services. However, his research shows that a good deal of the ill health and functional disability of the elderly is due to preventable diseases. Targeting and reducing these illnesses "could significantly lower the demand for long-term care services," he argued.

A recently developed method of regulating the consumption of health care services could also successfully control hospitalization costs, he continued. This so-called "DRG" system is based upon fixed reimbursements to hospitals for their treatment of a long list of diagnosis-related groups; for example, hospitals would be paid specific amounts for appendectomies, for cancer treatments, and so forth. Long-



Health and Welfare Canada

The elderly population is growing fast

term care will also have to be included in this reimbursement scheme to keep costs under control throughout the system, Manton concluded.

Changing the behaviour of "hospital-prone physicians" could have more impact on the health care system than growth in the numbers of the very elderly, commented discussant Noralou Roos, professor in the Department of Social and Preventive Medicine at the University of Manitoba.

Roos noted that "the great majority of elderly individuals . . . are healthy and infrequently hospitalized." Only a small percentage of old people – the very elderly and the dying – actually spend lengthy periods in hospital. But the hospital days taken up by these patients are insignificant compared with the hospital stays attributable to the practice style of some well-intentioned doctors. Consequently, Roos observed, in Manitoba "a 10 per cent increase in the numbers of the very elderly might lead to an increased 'need' of approximately 6,952 hospital days, while a 10 per cent increase in physicians who are hospital-prone would result in an increased 'need' of 34,956 days." The availability of hospital beds gives a similar boost to hospital admission rates, she added.

The answer, in her view, is better control of the numbers of doctors and an investigation into why some hospitalize their patients more than others. Active hospital admission review committees might be the answer, she concluded.

Floor discussion

The concept of community care generated a good deal of discussion. Several participants cautioned that inadequate care in the community could work against the elderly. One observed that numbers of old people die of hypothermia in the United Kingdom each winter; another commented that people over 55 suffering from kidney disease in the United Kingdom were not given dialysis. Walker agreed on the need for effective community care but pointed out that the dialysis decision had been taken at the hospital level, not in the community.

Another participant remarked that switching from a medical to a social care system could put doctors out of work and thus might be resisted. Manton replied that downward pressure on doctors' salaries, rather than job loss, would be the likely outcome of this change. Roos's reference to hospital-prone physicians also attracted attention. One participant queried whether longer and more frequent hospital stays might not imply improved care rather than the reverse; but Roos said she found "nothing to suggest that this practice style is good for the elderly." She noted as well that doctors disagree about the most effective form of treatment in many cases, and she recommended more research in this area.



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Recognizing the benefits of community life

Long-term care services

Institutional care need not be the only recourse for ailing or frail senior citizens, said Dr. Duncan Robertson, a consulting specialist in geriatric and internal medicine at the Juan de Fuca Hospital Society in Victoria, British Columbia. An integrated range of long-term-care services could, in fact, prevent or postpone admission to institutions in many cases.

Long-term health care has five essential components, he observed: acute care (in hospitals), primary care, facility care (such as old-age homes), home health care, and case management. Acute care is presently overutilized: in many parts of the United States and Canada, the elderly account for half of all hospital bed-days. This usage could be reduced significantly, Robertson claimed, with more effective and earlier discharge planning and with efficient geriatric assessment – that is, full diagnostic and functional evaluation as a prelude to arrangements for treatment.

The role of long-term-care facilities could be expanded to minimize unnecessary permanent admission to institutions, Robertson continued, by greater use of geriatric rehabilitation programs, by respite care (whereby family care-givers are provided with short periods of relief), and by day programs that provide specialized social and recreational opportunities for the mildly disabled elderly. Home health care is yet another option for the elderly, depending on their needs and on those of their families.

One important element in long-term care is the coordination of social and health care services, Robertson noted. That function is best carried out by a case manager, who is able to bring together all available resources in each individual case. Successful case management requires that patients be referred for help while they can still benefit and that available support services operate collaboratively for the attainment of therapeutic, rehabilitative, or management goals, he said.

Robertson concluded with the observation that in the quest for cost effectiveness in health care, society should be "guided by humanitarian principles, not merely by cost considerations."

Discussant Greg Stoddart, an associate professor at McMaster University's

Department of Clinical Epidemiology and Biostatistics, elaborated further on Robertson's recommendation for an integrated long-term-care system, by focusing on three issues: the "crisis mentality" with respect to future health care needs; the nature of cost-effectiveness information; and an important new source of revenue for long-term-care.

The sense of impending crisis in health care shouldn't be exaggerated, he said, even though there are reasons for concern. The impact of aging on health care will occur slowly over the next 50 years, he pointed out, and will primarily affect the institutional services sector; and demographically generated increases in health care spending could be met by real economic growth of around 2 per cent a year. Society's response to these demographic changes will be a deciding factor in determining future costs, he added. Planning in that regard should be undertaken with care, however, and not with a sense of urgency.

Alternative services must be evaluated more clearly and honestly insofar as their cost effectiveness is concerned, he continued. Frequently new services or programs are not cost-saving but, rather, more effective *and* more expensive. While society may consider increases in quality of life to be worth large additional net costs, it should have the appropriate information at its disposal.

Finally, eliminating ineffective, inefficient services elsewhere in the health system could provide a new source of funds for long-term care. In his view, combining public funding with a better incentive system would be the right approach.

Discussant John Horne, professor of social and preventive medicine at the University of Manitoba, took issue with the idea that community care is necessarily better and cheaper. In particular, he criticized the findings of a recent report on health care delivery. The report, prepared by management consultants Woods Gordon for the Canadian Medical Association task force on the allocation of health care resources, explored the costs of four different approaches to health care: reducing the number of elderly in institutions and placing them in community care; reducing the number of mentally ill patients in special facilities; shortening hospital stays for people under 65; and using nurse practitioners more extensively. On the basis of this analysis, Woods Gordon argued that huge savings – $6.8 billion – were possible by 2021, primarily through the reduced institutionalization of the elderly.



Ottawa Civic Hospital

Long-term care services should be varied

Horne concluded that the report overstated the case for de-institutionalization. His analysis showed that total savings in 2021 were $0.8 billion less than Woods Gordon predicted. In particular, the savings from removing the elderly from institutions were "dramatically reduced" by a full $3.6 billion when more realistic assumptions were made about the costs of alternative forms of care. Horne also maintained that, on the other side of the ledger, the potential savings from the use of nurse practitioners, from an increase in the operational efficiency of hospitals, and from the elimination of some marginally ineffective medical services (such as chest X-rays and electrocardiograms) would increase potential savings by $2.8 billion. With this approach, savings could be made through the more efficient use of existing services rather than through changing the entire system, as Woods Gordon suggested.

Floor discussion

The question of the future cost of health care interested many participants. One observed that since the rate of aging is not uniform, costs increase in spurts rather than regularly – implying that resources will have to be shifted rapidly and without warning rather than slowly over time. Another participant argued that the proportion of resources devoted to the elderly becomes even more worrisome when the cost of financial support programs, such as pensions, is included. A U.S. participant suggested that the problem stems from moving people from system to system rather than treating them within one and the same system. Another U.S. observer commented that in his country people are beginning to object to escalating health care costs and to the addition of new programs. Stoddart remarked that while there appeared to be no such reaction in Canada to date, it could be triggered at any time. The remarkable feature of the Canadian system, he added, is its excellent record of cost control in the absence of any incentives.

Preventive care

A new way of evaluating the health care system would help in the development of effective future policy, contended Madeleine Blanchet, president of the Conseil des affaires sociales et de la famille (CASF), a Quebec government organization.

In 1982 the CASF developed an effective method of evaluation – a "quality of life" measurement that takes into consideration not only the life expectancy of an individual but also his or her ability to enjoy that life in good health. This approach is more comprehensive and thus probably more

accurate than current methods, she said. According to the new measure, life usually begins to decline in quality around the age of 60.

This perspective changes the priorities for health care policy, putting far greater emphasis on preventive care and the promotion of good health, she observed.

In the context of this approach, the CASF developed a scenario for the year 2000, at which time health care policy will be concerned with maintaining the health of increasing numbers of old people. The CASF identified six initiatives essential for effective preventive care at that time: a research initiative, in areas such as genetics and the environment; an information initiative, to acquaint the general public with important health care issues; financial incentives (such as tax breaks and subsidies) to encourage preventive care; a legislative initiative; action to reduce environmental health hazards; and action to change the financing methods with regard to both personal health care and therapy.

Discussant Donald Wigle, chief of the Bureau of Epidemiology at Health and Welfare Canada, argued that Canada must develop national health goals designed to improve health, to reduce the major risks to health (such as smoking), and to improve general knowledge about these issues.

The kind of health objectives Canada should be setting for the period 1983 to 2000, he continued, include reducing the overall risk of death by 25 per cent, reducing disparities in the risk of untimely death among low-income groups and among regions by 50 per cent, and reducing the number of smokers between 12 and 29 years of age to less than 10 per cent.

Mass intervention programs (such as fluoridization of water) have proved most successful in achieving specific goals in the past. Thus workplace smoking bans would probably be a more effective form of preventive action than the establishment of smoking cessation clinics. The greatest gains will come from programs aimed at primary prevention, Wigle added, such as educating young people about the dangers of smoking.

In sum, education about avoidable health risks, along with legislation to control health hazards, is key to ensuring good health, he concluded.

There are few shortcuts in the journey to a healthy old age, commented discussant Carol Buck, a professor in the Department of Epidemiology and Biostatistics at the University of Western Ontario. The most important requirement for a better life in old age is a better life in infancy, childhood, and adulthood, she said.

People are the product of not only their genetic and prenatal inheritance but also a variety of lifetime experiences, Buck pointed out. So, for example – as her own research suggests – childhood infections may affect an individual's health later in life. Similarly, dental decay can lead to nutritional problems in old age, and high levels of noise over time can cause hearing impairment.

The implication is that preventive health care must begin early in life, Buck concluded. Sudden lifestyle changes – except for cessation of smoking – are not necessarily as beneficial as popular theory holds. For example, the effects of alcohol, diet, and exercise on health are quite complicated and deserving of a good deal more research.

Floor discussion

In the course of the floor discussion, a number of participants stressed the need to distinguish between health promotion and primary care (care in youth), on the one hand, and disease prevention, on the other. Several referred specifically to the disabling diseases, such as arthritis, that frequently strike the elderly. Although these concerns are interrelated, it was pointed out that each requires a different strategic approach and has different targets. Health promotion, for example, is a communitywide or countrywide affair, while the management and prevention of geriatric diseases has a narrower focus.

Another participant queried Wigle's approach to disease prevention. She argued that the costs of prevention can be higher than those of treating the disease itself, citing a U.S. study which found that screening of the entire population for hypertension can be more expensive than treating subsequent heart attacks.



Linda Carrier

Preventive care begins in childhood

Advances in technology

Senior citizens will be better off in the future than they are now, thanks in large part to technological innovations. But these technologies will have to be used wisely to ensure that costs do not get out of hand, said David Banta, a consultant for the World Health Organization in the Netherlands.

Since 1950, there has been an explosion of biomedical knowledge, both in diagnosis and in treatment, he observed. Often these new technologies are designed to compensate for the incapacitating effects of certain diseases or to postpone death – as in the transplant of artificial organs, or kidney dialysis, for example. Such technologies are very expensive, he pointed out: artificial heart transplants, for example, could end up costing the

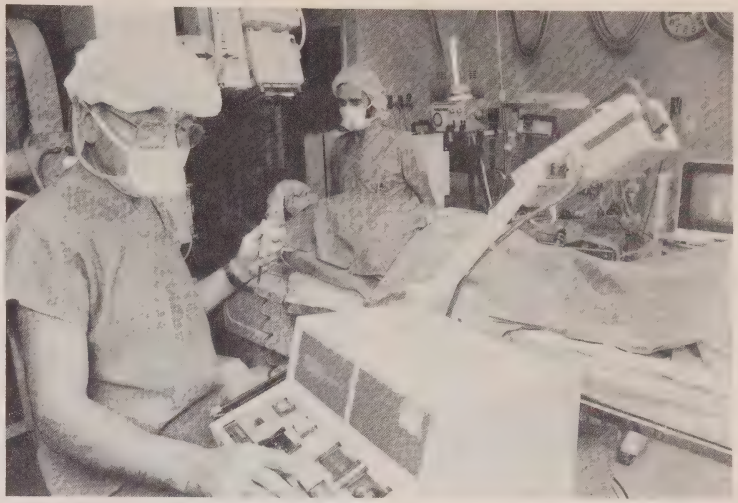
United States about $1-to-3 billion annually.

What's needed, in Banta's view, is a health policy framework to control or channel technological development. Increasingly, governments are recognizing that budget constraints are the most important form of control, and there is a general movement to prospective budgeting along the lines of Canada's global hospital budgets. That process requires an assessment of the benefits, risks, financial costs, and broad social impact of new technology, Banta said. While this kind of evaluation can be tricky, the most utilized and effective technique appears to be cost-effectiveness analysis, which indicates the benefit derived from the cost incurred. One such analysis, conducted by the Office of Technological Assessment of the U.S. Congress, found that using an influenza vaccine created "a healthy life for the cost of $63 a year (per person)." But Banta cautioned that the cost-effectiveness method should not be used in isolation. Judgment, as well as political and other considerations, should continue to affect decision-making.

Discussant Roger Evans, a senior scientist with the Health and Population Study Center in Seattle, Washington, said that rather than ignore or criticize new medical technology, we should focus on how much and what type we can best afford in current circumstances.

One of the most difficult and sensitive problems confronting health care policy-makers, he observed, is having to put a dollar value on lives, as cost-effectiveness analysis does. It's critical, therefore, that the best information on cost effectiveness be available for the assessment of any new technology. Once we accept that principle, Evans said, we're very close to developing consistent health care policies.

Quality of life is an important consideration in this assessment but one that is difficult to evaluate. According to Evans, this concept has both an objective dimension (functional ability, ability to work, and health status) and a subjective one (well-being, psychological condition, and life satisfaction). His studies of both kidney and heart transplant patients indicate that while they do not tend to score well on the physical scale, they do well subjectively – suggesting that they adapt remarkably to their situation. These findings, which probably apply equally to the elderly under long-term care, suggest that measuring the quality of life is not as straightforward as it might appear to be.



Ottawa Civic Hospital

New technology should be treated wisely

Evans went on to argue that some technologies – such as heart transplant therapy – are cited as expensive experiments, when most insurance companies view them as standard benefits. That inconsistency, in Evans's view, stems from a reluctance on the part of policy-makers to popularize costly procedures. A key issue in the health care field, he concluded, will be to determine not how much a new technology costs but, rather, "how much we can afford to spend on the care of the dying patient, regardless of the approach to treatment."

Discussant Raisa Deber, a professor at the University of Toronto's Department of Health Administration, noted that provincial governments haven't entirely succeeded in controlling the explosion in medical technology, even though they hold the health-care purse strings. That is probably because society finds it hard to ration services that delay death, she said, particularly when it is easy to identify with the individual lives at stake. In her view, policies restricting these technologies are unlikely to be adopted, since "only curmudgeons attack artificial heart transplants." A better approach, in her view, lies in eliminating demonstrably inefficient procedures.

Future technologies promise to create new problems, she added. In particular, those dealing with genetic diseases, although cost-saving, may challenge the basic ethical premises of our society. Other technologies, such as computers to assist in diagnosis, will be an invaluable aid to doctors in years ahead, she concluded.

Floor discussion

A wide-ranging discussion of technological issues followed the presentations. A number of participants pointed to signs of an anti-technology backlash, particularly with regard to the dying process, or to childbirth. Several noted, however, that this reaction is directed at inefficient technologies, such as fetal monitoring, rather than at technology in general.

Also raised was the question of how new technologies should be assessed: in closed fashion by experts, or openly, with feedback from the general public. The latter approach is preferable, Banta commented.

Whether technologies will be cheaper in future was also debated. If costs are expected to go down, then financing decisions should be long-term, noted one participant. Another argued that since labour (nursing, for example) makes up a high proportion of the costs, no large reductions are likely. Another contended that the scaling-down of hospital technologies – for example, hospital laboratories – is inevitable.

Ethical questions

As increasing numbers of Canadians grow older and health care costs continue to climb, certain ethical

questions take on increased significance. Three such concerns were raised by professor Jack Gallagher, of the Cardinal Carter Centre for Bioethics at St. Michael's College in Toronto, in his discussion of the topic "Economic Limits and Bioethics."

To begin with, he dealt with the contention that Canada cannot afford to provide its old people with increasingly costly health care. In his view, that attitude fails to address the real problem, which is one, not of mounting costs but of "our inability to apply our productive capacity to the needs of people," including their health care requirements.

Second, he discussed the priority that should be given to health care for the elderly, given queries about their entitlement to large expenditures in this regard. Cautioning against the attitude that aging lives are worth less than young ones, he suggested some guidelines for determining when life should be preserved by active means. These include developing a respect for the value of life and for the importance of preserving it; paying attention to all the needs of the elderly, as opposed to simply the physical ones; and placing emphasis on restoring health or alleviating pain rather than on maintaining life at all costs.

Finally, he queried whether health care resources should be utilized on the basis that some lives are more valuable than others and thus more entitled to medical attention. It would be mistaken and inhumane to establish priorities that exclude a large group, he maintained, arguing that with respect to this kind of decision-making, "chance is by and large preferable to choice."

Discussant Margaret Somerville, a professor at McGill University's Faculties of Law and of Medicine, outlined a number of pressing ethical concerns at both the practical and the theoretical level. In practical terms, she said, we need to recognize that medical issues cannot be examined in isolation: the legal, social, economic, and symbolic aspects of health care are equally important and interrelated. The law could prove helpful in resolving some of the complex questions that are presently being raised and in establishing an effective decision-making framework, she observed, since in its widest sense a society's laws reflect its values and culture.

We need to determine the guiding principles of decision-making in the health care field, Somerville argued, noting that fairness, informed neutrality, and creativity are critical elements of this process. As well, health care professionals should work from a clearly established set of values. Those guidelines require replacing the current "rigid, technological, simplistic, decision-making model" with a flexible, protective, and humanistic one, she concluded.



Health and Welfare Canada

Aging lives have value

Sister Nuala Kenny, head of the Department of Paediatrics at Queen's University, introduced her discussion of this topic by observing that decision-making on health care issues has become more complex in this era of medical and technological advance.

She contended that certain issues badly need clarification before ethically valid decisions can be taken. Most important, in her view, is the development of a sound philosophy of health care, affirming that health is a complex state and much more than simply the absence of disease.

Current financial restraints underscore the need to look carefully at the decision-making process in order to establish priorities. Above all, she concluded, all decisions should "preserve both the integrity of the individual and the integrity of the community."

Floor discussion

Ethical questions are complex and difficult to resolve, commented several participants. One noted that for many people, these concerns have a religious foundation; and so, since religious views vary, agreement is hard to reach. Gallagher agreed with this observation but suggested that efforts should be made to establish areas of common ground. Kenny added that ethics committees serve a useful role in this regard.

Another participant pointed out that ethical training should be given not only to health providers but also to managers and administrators. In reply, Somerville referred to a new approach whereby important health care decisions go through several levels – including the doctor and the administrator – before they are approved.

Planning for the future

A better system of providing Canadians with health care services would be more innovative, effective, and cost-saving, claimed Claude Forget, a partner in Sécor Ltd. and a vice-president of the C. D. Howe Institute.

Canada's present health-services delivery system is good, but it could be even better, he observed. As it stands, there is little room for innovation or change – two qualities that will be badly needed in the future. The problem, Forget said, is that the "powerlessness of all the players" to make changes in the system creates "frustration, staleness, and resentment."

This inflexibility can be explained by the fact that the present system is run by governments, which lack the incentive to make improvements or provide orientation. As well, the "professional

bureaucracy" of medical and hospital interests militates against change, as does a prevailing "ideological commitment" to all the features of the system. Finally, the assumption that the health care system should function with perfect rationality and consistency inhibits the growth of innovation and change, which are by nature "messy," he said.

A much more appealing arrangement, in Forget's view, would be a competitive system, better geared to consumer preference, individual initiative, and responsible management by doctors and other providers. A system recently established in some areas of the United States might meet these requirements, he observed. Under this approach, Health Maintenance Organizations (HMOs), run by doctors, undertake to provide health services to the public in return for an annual fee per patient. Since doctors collect the profits remaining once service costs have been paid, they have an incentive to keep their clients healthy (or to minimize the costs of illness), while clients in turn have the freedom to choose the best providers.

Forget also recommended putting hospital management on this kind of footing, by allowing HMOs to buy hospital services on behalf of their subscribers. This client/supplier relationship would improve management and boost efficiency, he concluded.

Discussant Jacques Brunet, director general of the Centre Hospitalier of Laval University, warned that the health system will need streamlining if it is to cope with future health care needs. A larger elderly population, accompanied by more chronic disease and additional new therapies, will place a heavy burden on hospitals in the years to come.

At present, Brunet said, neither consumers nor doctors have the incentive to moderate their use of hospitals. However, he noted, evidence from the American Hospital Association bears out his belief that the "DRG" approach (whereby hospitals are reimbursed for their treatment of specific ailments) could effectively limit admissions and control costs.

In conclusion, he recommended that hospitals in future be linked to the community through the establishment of extramural (community-based) hospitals.

Two major points were stressed by discussant Fraser Mustard, president of the Canadian Institute for Advanced Research in Toronto.

First, he agreed with Forget on the need for a more competitive health care system, giving doctors the incentive to deliver services efficiently. The ideal system would combine Canada's current public funding approach (ensuring equity of access) with more freedom to innovate. The HMO scheme, as described by Forget, might prove successful in this regard, he said.

Second, he argued that "the social structure or arrangements for supporting older individuals in the community are the most important questions for this conference." In his view, community health care should be provided primarily by non-professionals assisted, when necessary, by health service providers. Measures to encourage this kind of support should include the provision of paid employment leave to relatives and friends of the dying, "to allow the end of life to be as humane as possible."

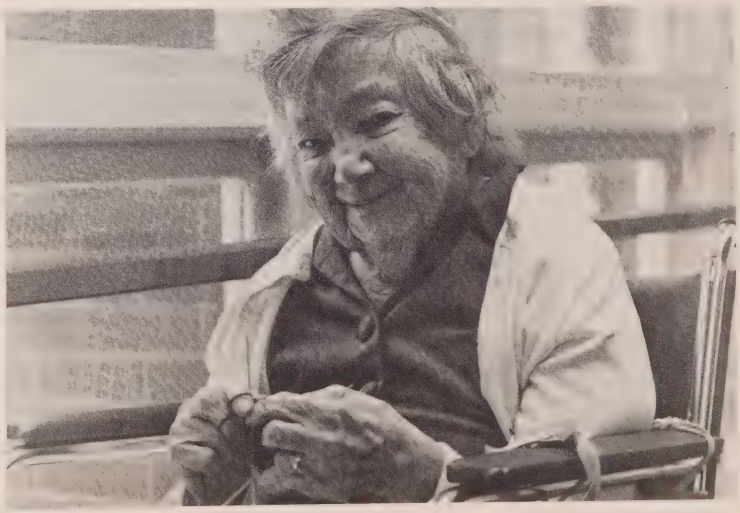
Floor discussion

Forget's proposal for change drew a number of questions from the floor. One participant commented that he did not find a sense of powerlessness in the health care system but, rather, a power struggle between the doctors and the provincial governments. Another added that in the kind of closed financial system characterizing this sector, there is a loser for every winner; he recommended more flexibility in terms of resource allocation, both overall and at various levels of the system. Another participant observed that a more flexible system would not necessarily be more inequitable but, instead, could attract more resources for lower-income groups.

On another subject, one participant questioned the value of Brunet's proposal for more extramural hospitals. He argued that efforts would be better directed at solving the problems of conventional hospitals, which are presently locked in intense competition for limited resources.

The issues raised at the Colloquium were summarized by dinner speaker Monique Jérôme-Forget, vice-rector of Institutional Relations and Finance at Concordia University. She concluded with four recommendations "of the utmost importance" for health care in the future: the establishment of clear objectives to improve overall health by the year 2000; the development of a first-class information system; the increased use of cost-effectiveness and cost/benefit analysis; and the introduction of a new system emphasizing prevention and cost-effective techniques.

In her closing remarks, Council chairman Judith Maxwell pointed to "incentives and integration" as key initiatives in future for Canada's health care system. While Canada should not unquestioningly imitate foreign systems, she continued, there are valuable lessons it can learn from other countries, particularly with respect to the importance of innovation and change. As well, Canada should be working to break down the barriers between its social and medical systems, while encouraging people to develop a sense of personal responsibility for health care.



National Film Board of Canada

Planning for future needs

The other side of new technology

Glamourous gadgetry like robots and satellites, Concordes and Canadarms, have helped to revolutionize the workplace.

But not so obvious are the effects of the "soft" technologies that have supplemented these developments. One example is statistical process control (SPC), which uses basic statistical methods to improve quality control. The success of a product in meeting certain engineering specifications (such as weight and dimensions) is charted over time. The patterns of variation may reflect material quality, environmental conditions such as heat or pressure, servicing intervals, and operators' skill. Hence the technique can be used as a diagnostic device to identify potential sources of trouble. Production workers trained in its use also become their own quality-control inspectors. Manufacturing industries in Canada are rapidly adopting the technique.

A closely related concept is "just-in-time" (JIT) inventory control, which, as the name implies, helps companies keep costly stocks to a minimum. In this way, companies also impose high standards of quality control, since with limited stocks there is no room for rejects. Thus SPC and JIT go hand in hand.

These and other innovations (such as robotics and lasers) are described in a guide to new technologies (and glossary of terms) being produced for the Economic Council as part of its project on the impact of tech change on the labour market (*Au Courant*, vol. 5, no. 4). The guide is being prepared by project director Keith Newton and consultants from Words Associated.

In a separate background paper, consultant Jacquie Mansell looks at one important example of "soft" technology – workplace innovations that emphasize the human side of the enterprise. She contends that such innovations – including changes in management style and philosophy, decision-making methods, job design, and organizational structure – may be as far-reaching in their impact on corporations as "hard" technologies that result in better machinery or equipment.

Creative management

Mansell explains that many factors – the recent recession, concerns about productivity, fierce international competition – are forcing companies to embrace imaginative and creative approaches to management. North America's fascination with the Japanese experience stems partly from the way in which technological advances there have been accompanied by equally progressive changes in job design, with the involvement and commitment of the work force. Working more productively and more co-operatively helps get the best out of hard technologies.

Canadian initiatives

In Canada, a number of workplace innovations have evolved over the past 15 years. Early management initiatives were motivated by the twin goals of work humanization and (though early proponents were reluctant to voice this) "bottom line" concerns such as increased productivity, reduced turnover, absenteeism, and industrial conflict. The efforts tended to focus on improving job satisfaction and morale. Thus programs of job redesign, involving the enlargement, rotation, or enrichment of individual jobs, were increasingly popular in the 1970s. (Job rotation and enlargement involve increasing the number of workers' individual tasks and are most commonly used in unskilled and semi-skilled assembly, clerical, and warehousing work. Job enrichment gives workers more skilled or responsible tasks, including basic planning, scheduling, and administration.)

Improving communications

Because poor communication was often blamed for low morale and job dissatisfaction, the common response was to establish union/management committees to share information, in an attempt to deal with problems before they festered and grew. Ontario Hydro and the International Nickel Company of Canada experimented with this approach in the early 1970s. The federal government subsequently established a program to encourage the development of these committees, as did provincial governments in Alberta, Ontario, and New Brunswick. Since 1979, the Preventative Mediation Program in Ontario has helped as many as 10 "joint action committees" get started each year. Both job design and communication programs in general have enjoyed varying degrees of support and commitment, and thus mixed success, Mansell concludes.

> *Technology and people are interdependent; only by mutual accommodation will each produce its best.*

"Sociotechnical systems"

A more recent development has been the shift to a broader view of organizational effectiveness, which explicitly recognizes that the technological and social (or human) sides of the enterprise must be jointly fashioned. Technology and people are interdependent; only by mutual accommodation will each produce its best. A program that attempts to take advantage of this synergistic, symbiotic relationship is called a "sociotechnical system" (STS).

A world-famous example of how this system works is found at the highly automated and technically complex Shell Canada plant in Sarnia, Ontario, where chemical workers and management have jointly planned, designed, and implemented a thoroughgoing commitment to STS. The cornerstone of the Shell system is the self-regulating (or "semi-autonomous") work

group: teams of workers typically assume responsibility for their own work scheduling, training, overtime planning, and even hiring. Job rotation, which encourages team members to become multi-skilled, is reinforced by a "pay-for-knowledge" system that sets wage rates in accordance with a worker's skills. Hierarchical control is downplayed in favour of participation and group responsibility to promote co-operation, flexibility, and problem-solving. The emphasis is on change as a continuous process. Openness and participation encourage and support continual learning; thus the organizational design is self-sustaining. For Shell, the results speak for themselves: output levels are high; maintenance standards and quality control are excellent; grievances, few; and absenteeism, low. The company has recently incorporated the expression "sociotech" in its television commercials.

Industrial survival

Another impressive example of STS can be found at the Canadian General Electric plant in Bromont, Quebec, where employees received bonus payments of close to $1,000 each in 1984, under a plan that rewards them for cost-saving initiatives. At Pratt and Whitney Canada, the commitment to STS at its new operations in Halifax, Nova Scotia, involves combining the most advanced technology with the most innovative organization of work. Said a senior company spokesman in a *Globe and Mail* interview: "The aim of this combination . . . is nothing short of industrial survival."

Mansell points out that STS appears particularly well-suited to capital-intensive, highy integrated, and complex technologies. That's because rapid, flexible, and high-quality diagnosis and problem-solving are at a premium in these operations. But STS is not limited in scope and has been introduced in warehousing operations, unionized settings, and in numerous office situations (including the Ontario Ministry of Consumer and Commercial Relations).

Lessons for the future

If all the stakeholders in an organization want change, there now exists considerable information to help them avoid some of the mistakes of the past. A few simple points appear important. First, programs of change are more likely to succeed when supported by strong and stable leadership from management and unions. To work together effectively the parties must have built a relationship of mutual respect and sensitivity. Second, workplace innovations must be custom-made rather than adopted wholesale, to avoid "re-inventing the wheel." Paradoxically, however, an essential ingredient of success is that parties work together on their own design, thus sharing a learning experience and ultimately "owning," and identifying with, the structure they implement. Third, innovations do not last long in enclaves of the organization; significant results are more likely to emerge from plans that are establishmentwide. Fourth, resources are necessary; money, time, and (most of all) people must be devoted to the change process. The prospects for success are better when competent, respected, and influential people are involved. Fifth, organizational change must be regarded not as a "one-shot" deal but as an ongoing process. What was effective yesterday may not be adequate tomorrow. Finally, international experience suggests that new organizational forms and modes of behaviour are more likely to survive and succeed within the context of broader acceptance, by society in general, of participation and collaboration.

For their part, economists have to reconsider the concept of technological change. Instead of viewing it simply as a process in which the inputs of production (such as capital, labour, materials, and energy) are used more efficiently, their analysis has to take account of the impact of advances in soft technologies. In fact, if this aspect is overlooked, even the most-advanced hard technologies may prove ineffective.



Current activities at the Council

The Council is presently at work on projects to do with industrial policy, labour and social policies, international trade and finance, public finance, and the monitoring of economic performance. A brief summary of its current research activities follows.

Industrial policy

Government enterprise

Debate about the extent of public ownership and the performance of government-owned corporations prompted the Council to look at the role of government enterprise as one of a number of instruments of public policy. The research report will make proposals with respect to the use of commercial public corporations and the problems of accountability and control.

Financial institutions

The Council will focus on the trade-offs between major policy goals (such as competition and solvency) that Canadian governments have to consider in revising legislation. It will also look at ways to improve the efficiency with which financial services are provided to all Canadians.

Adjustment of firms to trade

How manufacturing firms adjust to changing market conditions is the focus of yet another project, with a final report expected in the summer of 1987. Under particular consideration are Canadian and foreign-owned firms; the births and deaths of firms on an industry basis; and the different impact on various firms in Canada of bilateral (Canada-U.S.) and multilateral trade liberalization, especially the degree of adjustment within industries relative to that between industries.

Public finance

Taxation of capital income

This report, to be published late in 1986, will identify the shortcomings of the current taxation system with respect to income from capital (including property) at both the corporate and personal levels. The Council will recommend ways to improve the efficiency and fairness of capital income taxation, giving special emphasis to the relative merits of both consumption and income taxes.

International trade and finance

Trade policy options

This project will carry out simulations of the growth and employment effects of implementing Canada's major trade policy options, including both bilateral and multilateral trade, as well as of the impact of changes on both tariff and non-tariff barriers. Interim results will be released in late 1986 and in 1987, with the final report due early in 1988.

Monitoring of performance

Annual Review

The Council's *Twenty-Third Annual Review* of the performance of the Canadian economy will focus on structural change and on the medium- and long-term outlook for the Canadian economy.

CANDIDE Project

The CANDIDE group is responsible for the maintenance and updating of the Council's large-scale econometric model. Its work provides the basis for the Council's medium- and long-term projections and policy analysis. In addition, the group provides analytical data for other projects, including taxation and trade simulations.

Labour and social policies

Impact of technology on labour markets

Researchers will make projections concerning the likely effect of technological change on future employment and the occupational structure. A survey of firms, case studies, and broad discussions with labour, industry, and government will be part of the research effort. The final report, due in the summer of 1987, will include recommendations on a variety of policies for assisting adaptation to change in such areas as education, training, mobility, and income redistribution. An interim report on the survey results will be released in the fall of 1986.

Labour adjustment to structural change

This project will analyse how workers adjust when they lose their jobs and how effective labour market policies (such as training) are in helping those workers to find jobs. Interim results will be published in the spring of 1987, with a final report expected in 1988.

Mergers can boost competition

Corporate mergers may be better for the economy than hitherto thought, according to new Council research.

Instead of reducing competition, they can also enhance it – either by enabling new competitors to enter markets where competition might be lacking or by permitting small firms to rationalize production and become more competitive. On the whole, mergers "appear to be part of a process symptomatic of a healthy economy," says a new council paper by economists John R. Baldwin of Queen's University and Paul K. Gorecki of the Economic Council.

Until now, disagreement over the effects of merger activity has stalled efforts to revise federal legislation that is generally seen to be ineffective in this area. Some observers argue for more stringent legislation to prevent the formation of monopolies or oligopolies, which may use their market power to charge higher prices and curb competition. Others contend that mergers have little impact on the concentration of market power within industries and that screening them is unnecessary. The authors' evidence "emphasizes the need to be extremely selective in devising a merger policy."

The paper examines the "horizontal" and "diversified" mergers that took place in the Canadian manufacturing sector between 1970 and 1979. A horizontal merger is one in which competitive companies in the same industry merge. This is more apt to create market power than a diversified merger, where companies in unrelated businesses merge.

Declining importance

What the authors find is that horizontal mergers have declined in importance. Multiple mergers of either kind are much less common. No matter what type of merger, larger companies generally acquire smaller ones. But, the authors conclude, the level of merger activity between firms of comparable size suggests that this process actually "strengthens small firms' ability to compete," by allowing them to achieve economies of scale.

The authors explain that mergers play an important role in allowing firms to enter the market and to expand. In fact, almost as many firms grow by horizontal merger as by the building of new plants, for example. Similarly, entry by diversified merger ranks equally with new plant creation, when measured in terms of sales. But, since merged plants are generally larger than new ones, they are better able to compete against the largest competitors in their respective industries.

To determine the importance of the merger process, the authors examine the circumstances that influence a company to merge rather than build a new plant. The results are given separately for both foreign-owned and domestic firms.

The entry process

For domestic firms, entry by diversified merger or by new plant creation depends on such factors as the number of existing firms in the industry and the growth of the market. Foreign-owned companies are more concerned with global considerations. In both cases these mergers are more likely to occur in "concentrated" industries (where market power is held by relatively few firms, making it difficult for new competitors to enter the market). This is particularly the case for foreign-owned firms. Hence these mergers overcome entry barriers and are "potentially procompetitive," the authors suggest.

The expansion process

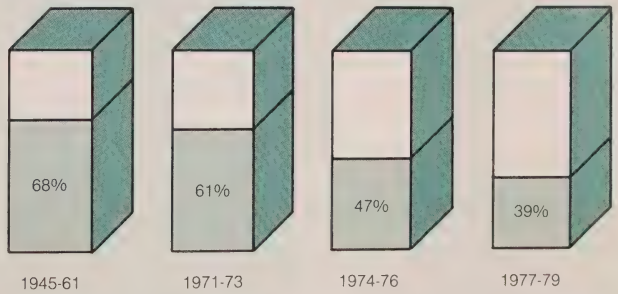
Similarly, the evidence for both foreign-owned and domestic firms is that mergers of the horizontal variety occur mainly as part of a rationalization process in which firms take advantage of greater economies of scale. In fact, even when the size of the minimum efficient plant is increasing, mergers by domestic firms are still more common than new plant creations. Among domestic firms, these mergers occur mostly in regional industries. Foreign-owned firms are less likely to engage in mergers in concentrated industries.

Overall, both types of mergers respond to much the same forces that influence new plant creation – such as profitability. In this respect, the argument that mergers in some sense create higher profits through the creation of market power is less credible, the authors note. The merger process, in fact, "is not an aberrant one that is dramatically changing the structure of the manufacturing economy," they conclude. While merger activity does have competitive consequences, a broad policy either encouraging or discouraging it "is probably inappropriate," they add.

"Mergers and merger policy in the Canadian manufacturing sector: 1971-79," by John R. Baldwin and Paul K. Gorecki. Discussion Paper No. 297.

Horizontal mergers have declined in importance

(as a percentage of total mergers in Canada)



Newfoundland revisited

After weathering the near bankruptcy of its fish-processing industry, the Newfoundland fishery has brighter prospects in sight.

But there are still too many fishermen chasing too few fish, which limits full-time work in the industry and forces many fishermen to accept unemployment insurance benefits as a significant source of income. The situation has become progressively worse since 1980, when the Economic Council issued its first major report on the Newfoundland economy. In an update of that report, economist Lawrence Copithorne (original director of the Newfoundland project) contends that unless governments deal with the plight of these workers soon, they "may bring the industry to its knees a second time."

One solution, in his view, is to establish a universal income subsidy that is not tied to the fishery. This would eliminate the need for workers to remain in the industry to be eligible for income relief under the special unemployment insurance scheme for fishermen.

Positive outlook

Meanwhile, other developments in the fishery since 1980 have been more positive. The recent shake-up in the fish-processing industry left most plants in the hands of a new Crown corporation – and workers there recently accepted real wage declines to help the company become profitable. Some industry sources claim that this agreement and the restructuring of the industry come from "a fundamental change" in attitudes that signals new co-operation between workers and management, Copithorne says.

Beyond that, a new system for allocating the offshore catch – one the Council had suggested be adopted in 1980 – has proven "very successful," he says; new fish stocks now under Canadian management as a result of the extended fisheries jurisdiction are recovering relatively well. The productivity of the Canadian trawler fleet has improved dramatically in response, he adds.

Hibernia oil

The brightest new hope for the Newfoundland economy lies in the prospect of developing the Hibernia oil field. At the moment, however, there is uncertainty over the costs of production, the size of reserves, and the impact of falling world oil prices. To make the project viable, governments need a fiscal regime that can aid the project in the early stages of development without undermining the prospect of collecting a substantial amount of economic rent in the future. A "profit-oriented" cash flow tax would work well in this respect, Copithorne finds. It would respond automatically to unforeseen fluctuations in project costs and oil prices; burdens would be shared and windfalls reaped in proportions determined by the tax rate.

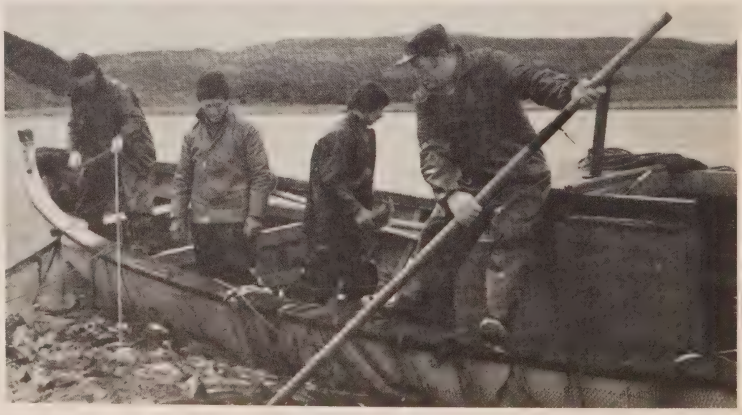
The labour market

In his analysis of the labour market, Copithorne finds that Newfoundlanders are generally much less willing than other Canadians to take wage cuts to get jobs. Indeed, even in the face of high unemployment in the province, the average hourly earnings in Newfoundland manufacturing jobs climbed above national levels in 1984, he points out.

Employment growth in Newfoundland remains sluggish. Its labour force participation rate is about 10 percentage points below the national average. Thus job creation has virtually no effect on measured unemployment, because the prospect of jobs attracts numerous new workers into the labour force. In other words, the official unemployment rate excludes the abundance of discouraged workers who have given up looking for employment. Unemployed workers also tend to get "bottled up" in the province during recessions, as a poor economy slows outmigration and encourages some Newfoundlanders to return home. This is partly the result of income subsidies that affect migration. Within Newfoundland these subsidies slow the process of urbanization and its positive impact on the economy; thus they should be removed, Copithorne concludes.

Subsidies for transportation to and within Newfoundland also adversely affect the economy by reinforcing a pattern of economic activity that is costly and counterproductive. Without these subsidies, for example, most freight would be shipped through Corner Brook and St. John's – the two largest markets in the province – instead of through smaller urban centres. Copithorne's update says the best hope for improving the transportation infrastructure is the development of Hibernia. The province should also upgrade the Trans-Canada Highway linking Newfoundland's major urban centres, he adds.

"Newfoundland revisited," by Lawrence Copithorne. Discussion Paper No. 296.



The fishery remains important

Cutting the cost of municipal services

The most cost-efficient way to deliver some municipal services is through private companies.

In the case of urban transit, for example, this method is "significantly less expensive" than using a municipal enterprise such as a local transit commission, a new Council paper finds. This is due largely to a lack of competition in the public sector, which reduces the incentive to improve efficiency and performance, says economist Harry M. Kitchen of Trent University, in research done for the Council's project on government enterprise (*Au Courant*, vol. 4, no. 3).

The author looks at the provision of urban transit, water, and electricity in Ontario, comparing the costs of delivering these services under different organizational structures. (For electricity this includes the repair and maintenance of local facilities only.) For both electricity and transit, Kitchen cites evidence showing that the use of private contractors may affect cost savings. As well, he indicates that for both transit and water the use of a government department is less costly than a municipal enterprise. One reason is that operating costs are reduced by using existing city hall resources, such as office space, accounting and legal services, and so on.

While most municipal enterprises were created to ensure more technically competent and carefully administered services, Kitchen queries whether this objective has been achieved. He finds that the proliferation of municipal enterprises undermines their effectiveness by generating conflicts among organizations seeking to promote their own special interests. Hence local governments would be better off having complete control over all municipal functions, the author contends.

The paper also examines the efficiency of pricing policies for municipal services and whether or not the organizational structure influences the type of pricing policies used. Kitchen finds no connection in the latter respect but does uncover some glaring inefficiencies in pricing methods. Practice in setting prices varies widely; it ranges from "flat-rate" or fixed charges, unrelated to the volume of service consumed, to "metered" charges that reflect volume, to a mixture of both approaches. The revenue from these charges covers anything from a small percentage to all of the operating costs.

For water, the flat-rate charges for residential consumption used by many smaller Canadian municipalities create excessive demand and in some cases result in considerable overinvestment in capital facilities. Even with some of the metered systems, consumers may not be billed for using increased quantities of water as long as their total bill remains below a minimum. Also, water charges may not take account of the proximity of water plant facilities to the areas being serviced, thus failing to reflect transportation costs. One effect is that these policies act as subsidies that can artificially raise land values, Kitchen explains.



He suggests a "multi-part tariff system" in which charges for connection and on-site expenditures would be incorporated into a pricing schedule that reflects all the costs of servicing different users. The concept of prices varying with seasonal or daily demand "should be seriously considered," he adds.

Municipalities have less control over the provision of electricity. Ontario Hydro, a provincial Crown corporation, supplies local electric utilities and largely determines rate increases across the province. But these rates do not often vary with demand; nor do they take account of the distance between customers and the source of supply.

While the provincial government provides large operating and capital subsidies for urban transit, local municipalities establish fare policies. The rates depend largely on the degree to which each government wishes to encourage public rather than private transport. This, in turn, is related to such issues as local development, the use of downtown parking lots, and urban sprawl. But failure to set fares in accordance with the distance travelled "makes little economic sense," Kitchen insists. In addition, subsidies that are completely unrelated to income – such as lower fares for senior citizens and students – are difficult to justify on efficiency grounds, he points out.

To make municipal services in general more economically efficient, pricing policies should be designed to cover the cost of providing these services (except where subsidies are required). Improved efficiency could also result from "altering the organizational structure of providing certain services in some communities," Kitchen concludes. What is needed, he says, is a "careful reassessment" of each existing municipal enterprise, possibly with a detailed study of a few services in selected municipalities.

"Local government enterprise in Canada," by Harry M. Kitchen. Discussion Paper No. 300.

S·P·E·A·K·I·N·G · O·U·T

How will Canadian industries fare in the wake of freer trade with the United States and other countries?

The Economic Council is addressing that question by looking at the adjustment and adaptation of Canadian manufacturing firms to various trade pressures and opportunities. In a new project, Council research will focus primarily on the impact of trade liberalization over the past two decades and look at the public-policy response to these and other trade-related changes. This should provide a yardstick as to what might happen in the future and help governments respond appropriately.

The results of the project are expected to be released in early 1988. To find out more about it, *Au Courant* interviewed project director Paul Gorecki.

Au Courant: *What will the project focus on?*

Gorecki: The project has two main parts. The first will provide an overview of the adaptation experience of the Canadian manufacturing sector. It will examine the way in which firms enter and leave industries, the way in which they merge, and how these activities are affected by changing trade conditions and particularly by trade liberalization. Particular attention will be paid to the behaviour of foreign-owned firms. The second part will be largely devoted to looking at four specific industries where governments have attempted to assist in the adjustment process, usually by providing some form of financial assistance and/or import protection. The four sectors are automobiles; pulp and paper; shipbuilding; and textiles, clothing, and footwear. We expect these examples to provide some valuable public-policy lessons.



Paul Gorecki

Au Courant: *What do we know about the adaptation of manufacturing firms in general? Have they been fairly successful to date?*

Gorecki: On the whole, yes. We know that poor demand conditions tend to discourage new firms from entering the industry rather than encourage a massive exodus. That means the brunt of the adjustment process – both good and bad – occurs through a change in birth rates instead of death rates, which is probably less painful.

Some people have overplayed the worst-case scenario in which they fear a massive exodus of foreign firms from Canada.

Our experience in terms of trade liberalization has generally been positive. Where tariffs have been reduced in industries characterized by high tariff levels and concentration (where few firms produce most of the output), we have seen growth in plant size and production runs. The ones facing import competition have in many cases managed to carve out specialized niches in the market.

However, there are still industries protected by trade barriers that are not likely to fare well if exposed to the winds of international competition. Indeed, future trade liberalization may bring more severe adjustment problems than we have seen in the past, simply because of Canada's policy of protecting industries that are probably the least competitive at the international level. In other words, the past might not be a good guide as to what may happen in the future. We intend to devote some attention to this issue.

Au Courant: *So trade barriers have tended to hinder industrial adjustment in Canada?*

Gorecki: Not necessarily. If, for example, a sudden influx of dumped goods threatens domestic jobs in an industry where we do have a comparative advantage, then it may make sense to provide temporary trade protection until such time as the world trade in this commodity resumes a more normal pattern. In other instances, it might be worthwhile to grant temporary protection so that industries can reorganize themselves to compete on a world scale. This may apply particularly to young industries that are not fully developed and where considerable economies could be realized once the learning process is completed. The real problem is that temporary protection often becomes permanent. The industries never reach a point where they can compete on a world scale. The so-called "infant" industries never grow up.

Au Courant: *How can governments prevent this from happening?*

Gorecki: It is unfortunately quite difficult to design and implement temporary trade protection measures. Perhaps there should be some sort of "sunset" provision, putting a time limit on protection. I think the onus should be on industries to demonstrate the benefits of temporary trade protection. Governments

should reflect on whether or not these industries will ever be internationally competitive. They should clearly define the problem being addressed. They should examine the alternatives and lay out the costs involved.

Au Courant: *Is there any reason for concern about the effect of foreign ownership on adaptation?*

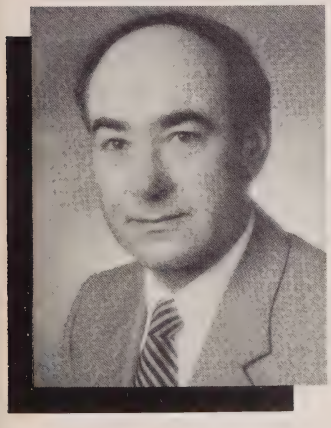
Gorecki: Yes, in the sense that a very large portion of the Canadian manufacturing sector is owned by foreign-based multinationals. Naturally, different constraints and opportunities affect the performance of these firms than affect Canadian-owned firms. Hence they may react differently to falling trade barriers.

But I think some people have overplayed the worst-case scenario, in which they fear a massive exodus of foreign firms from Canada. We certainly did not witness any such occurrence over the last 10 to 15 years – a period when tariff levels fell considerably. Indeed, if Canada is able to negotiate secure access to the U.S. market, this will make it a more attractive place to locate new foreign investment.

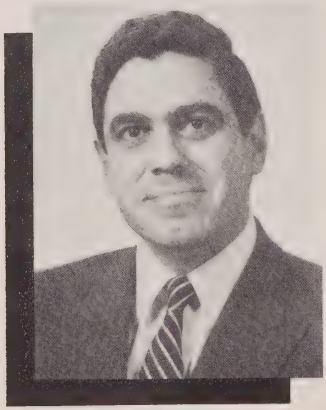
Au Courant: *Will Canadian firms be able to compete with their U.S. counterparts under a freer trade arrangement?*

Gorecki: It is usually argued that intra-industry trade – that is, trade in similar commodities, such as American beer for Canadian lager – will not cause big dislocations in Canada. Intra-industry trade normally takes place between countries of similar income levels and with similar capital and labour endowments. Much of our trade with the United States is of this variety. In the future, we are likely to see growth in the production runs and plant sizes of both Canadian and U.S. industries involved in intra-industry trade. An increase in this kind of trade may make it easier for Canada to move away from lower-value-added items to higher-value-added goods, which are better able to utilize Canada's supply of skilled workers.

New members appointed to the Economic Council



Martin Chernin is president of Kanso Development Corp.; Medallion Communications; and Cape Breton Cablevision. He is also an officer and director of several other firms, and is a former vice-president of the Chernin group of companies.



Constantine E. Passaris is a professor of economics at the University of New Brunswick. He has written for various newspapers, magazines, and journals on a wide range of economic subjects, and is the author of several books and monographs.

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Economic Council of Canada

Volume 7, No. 2 , 1986

The Council's annual review of the economy



More on technology

A new project on trade policy

PUBLICATIONS

New on Technology

The Economic Council has released two new publications on technology: a survey of Canadian employers, describing their experience with computer-based innovations; and a guide to new technologies in the workplace (see insert in this issue for more details). Both publications can be ordered in accordance with the information below.

Working with Technology: A Survey of Automation in Canada, by *Gordon Betcherman* and *Kathryn McMullen* (EC22-133/1986E; $3.95 in Canada, $4.75 elsewhere).

Workable Futures: Notes on Emerging Technologies, by *Words Associated* and *Keith Newton* (EC22-132/1986E; $5.95 in Canada, $7.15 elsewhere).

Annual Report

The Economic Council's Annual Report for 1985-86 is now available. It includes a message from chairman Judith Maxwell, as well as details on Council activities and research projects currently under way. For a free copy, write to the Information Division (address below).

Twenty-Third Annual Review

Changing Times (EC21-1/1986E; $6.95 in Canada, $8.35 elsewhere).

In its 1986 review of the economy, the Council looks at the prospects for freer trade with the United States, some problems in the resource sector, and the role of government. In addition, it includes the Council's medium-term outlook for the Canadian economy.

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the personal responsibility of the author or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 308 "The role of tax-deductible saving in the transition from a progressive income tax to a progressive consumption tax," by *Michael J. Daly*, *Gary J. Lastman*, and *Fadle Naqib*.

No. 309 "The impact of RRSPs on capital accumulation with progressive personal taxes," by *Robert Androkovich*, *Michael J. Daly*, and *Fadle Naqib*.

No. 310 "Current financial difficulties in Canadian agriculture," by *Pierre Cloutier* and *David MacMillan*.

No. 311 "Micro-computer simulation with a general equilibrium model of Canada," by *Sylvester Damus*.

No. 312 "Hydro-Québec : Les relations entre l'État et son entreprise," by *Roland Parenteau*.

No. 313 "Taxation of life insurance in Canada," by *B. Dahlby* and *A. Macnaughton*.

How to order

Research studies and Council reports are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion Papers, *Au Courant* and the *Annual Report* are available without charge from the Information Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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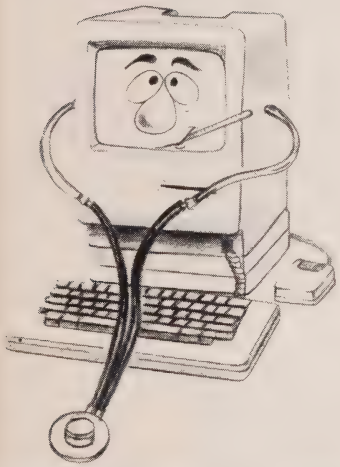
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Au Courant *est également disponible en français.*

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its staff and others. The findings of these reports are the personal responsibility of the authors. Neither the original publication of these studies and papers, nor their condensation for the purposes of this magazine, should be taken to imply endorsement of their conclusions and recommendations by the members of the Economic Council.

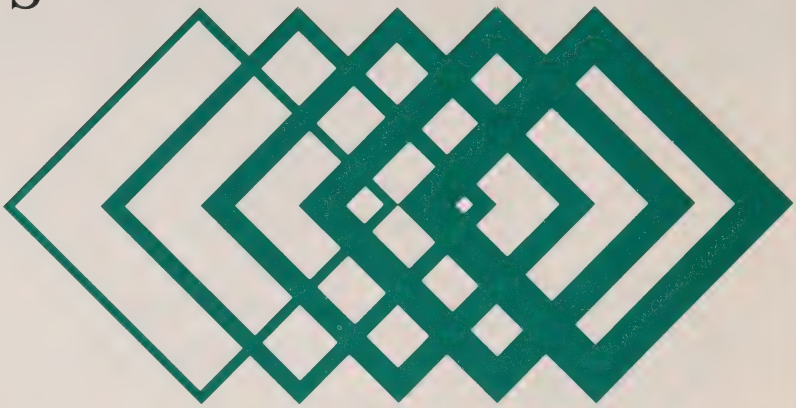
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Editor: *Barbara S. Campbell*

ISSN-0226-224X

CHANGING T·I·M·E·S



Canada must redefine its role in the resource sector, rethink its approach to public policy, and pursue its options with respect to freer international trade, says the Economic Council of Canada in its Twenty-Third Annual Review of the economy.

These issues require careful attention, the Council says, in response to the risks and uncertainties of changing economic times. The current climate of instability, it observes, is largely the result of the integration of national economies into the world economy, marked by a dramatic increase in the international flow of savings and trade, and in the transmission of knowledge and new technology. As national economies become increasingly interdependent, new policies are needed to facilitate adjustment and to reinforce Canada's ability to compete in world markets, says the Council. Given the unprecedented imbalances in world trade, debt, and budgets, national governments must also engage in more international coordination of effort, it adds.

Despite these uncertainties, the Council finds there have been some encouraging signs recently that the Canadian economy will grow significantly over the medium term. Real gross national product (GNP) is expected to average 3 per cent in 1986 – a performance that is superior to that in many other industrialized nations. Moreover, domestic demand has replaced net exports as the engine of economic growth. There have been impressive gains in productivity since the 1981-82 recession. Canadian interest rates have fallen significantly in response to lower U.S. interest rates and a decline in inflationary expectations. About 400,000 new jobs were created last year. And, for the first time in the current recovery, the contribution of real investment to growth was "substantial," the Council says.

Some problems have persisted, however. Unemployment has become particularly worrisome in western Canada, as well as in the Atlantic provinces. While real investment expanded at a healthy pace in 1985, the investment/GNP ratio remained historically low. Weak commodity prices, high real interest rates, and excess capacity may inhibit investment in the years ahead. As well, the size of the federal debt continues to be cause for concern.

International developments

A number of positive developments on the international scene should help prolong the current recovery, the Council observes. Inflation remains low and shows no sign of accelerating; the collapse in world oil prices should be of overall benefit to the consuming countries; and most industrialized nations have improved their fiscal/monetary policy mix and have shown increased willingness to cooperate in order to correct some of the serious imbalances in the world economy (such as the high value of the U.S. dollar and Third World debt problems).

The extraordinary pace of change in the global economy and here in Canada means that it is time to rethink policies in many areas. There are key changes to be made in the regulation of financial institutions; the government is beginning to reform the tax system and review some of the social programs in Canada. These initiatives will, in turn, alter the way in which businesses and individuals respond – their patterns of consumption, saving, and investment, for instance – which will inevitably affect the nation's overall economic performance. So the Council takes a look at the role of government in the years ahead (see page 6). Another area of uncertainty lies in the future of Canada's resource sector (see page 8), particularly with respect to energy, agriculture, and the condition of the environment. Above all, there is the prospect of freer trade with the United States and its impact on output and employment in Canada (see page 5). All of these issues are discussed against the background of the medium-term economic outlook, which is described on the next two pages.

Outlook for the economy

The Council's main projection of the key economic indicators – which it calls the "base case" – is founded on certain specific assumptions (on the past performance of the economy, for example, as well as its present position, on current information about its future course, on the outlook for foreign economies, and so on). Using this basic projection, the Council then tries out various scenarios or alternative cases to see how the economy would be affected.

According to this year's base case, the medium-term outlook suggests that over the next 10 years economic growth will average 3 per cent; inflation will dip below 4 per cent – the lowest level since the 1960s – but will subsequently rise above that level later in the period; and the unemployment rate will gradually fall to under 7 per cent by 1995. The commodity price slump, however, is likely to result in sharply increased regional pressures and will undermine, to some extent, the prospects of a strong surge in business fixed investment in regions that are heavily resource-dependent.

The charts on the next two pages indicate the outlook for six key economic indicators over the next five years. In each instance, the base case is compared with a "high-growth" alternative that assumes lower oil prices, a stronger Canadian dollar, higher productivity growth, and a more favourable U.S. performance; it is also compared with a "low-growth" scenario essentially assuming the reverse.

Unemployment

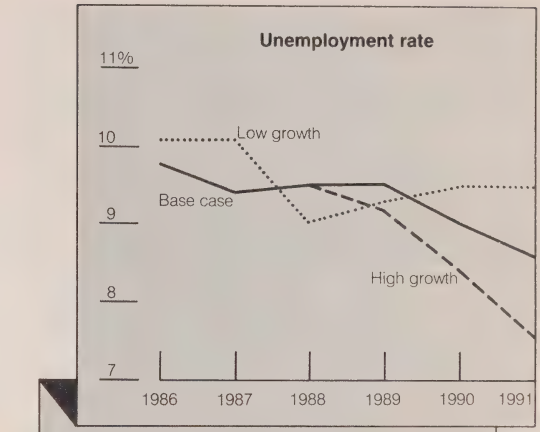
In the short term, the Council expects only modest improvement on this front. In the base case, the unemployment rate averages 9 per cent over the next five years, partly because growth in the labour force continues to keep pace with new job creation. In subsequent years, however, the reverse will occur, contributing to a gradual decline in the unemployment rate to below 7 per cent by 1996.

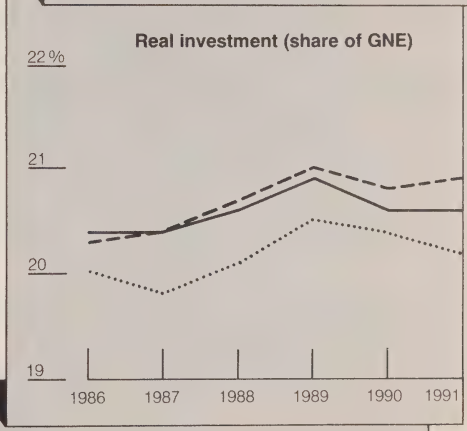
Real investment

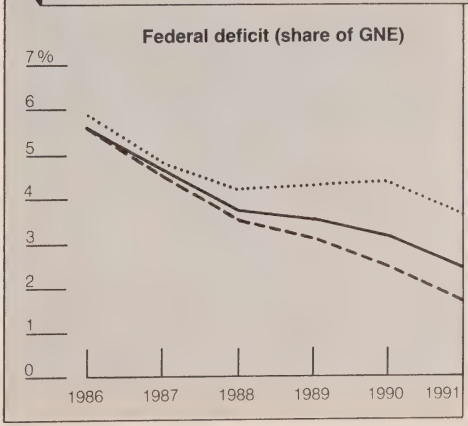
The weakness in investment spending (a concern in 1985) is another worrisome aspect of this year's outlook. The base case implies a modest recovery in business investment over the medium term, but investment as a percentage of GNP is not expected to recover significantly from its current low levels for a number of reasons: high real interest rates, depressed commodity prices for resource-based products, a dismal outlook for energy investment, excess capacity in many parts of the resource and manufacturing sectors, and general government restraint. The low level of business investment will constrain what are otherwise significant gains in productivity and real incomes, the Council explains.

The deficit

The initiatives taken in the last two federal budgets, combined with an improved outlook for employment, inflation, interest rates, and output, should lead to a







decline in the federal deficit – from $32.3 billion in 1985 to around $20 billion by 1990. Moreover, the federal budget balance (if interest payments are excluded) will show a healthy surplus over the next decade, similar to its record in the 1960s. As a consequence, the ratio of federal debt to GNP and the proportion of government expenditures required for debt servicing will peak around the turn of the decade and decline steadily thereafter.

Growth (GNP)

Economic growth should average 3 per cent annually over the projection period, with consumer spending and residential and nonresidential investment providing most of the stimulus. Strong gains in real incomes, supported by improved productivity and employment and a decline in the personal savings rate, account for much of the strength in consumer spending, the Council says. Real expenditures on goods and services by government will grow at a slower pace than aggregate output, reflecting government restraint. Despite fairly strong growth in exports, the contribution of the trade sector to real growth will remain slightly negative over the medium term – the result of extensive debt-servicing expenditures. The Council is in fact projecting a small current-account deficit over the period. Thanks to a better inflation projection and significant improvement in the federal deficit, however, the value of the Canadian dollar in relation to U.S. currency will continue to hover in its present range.

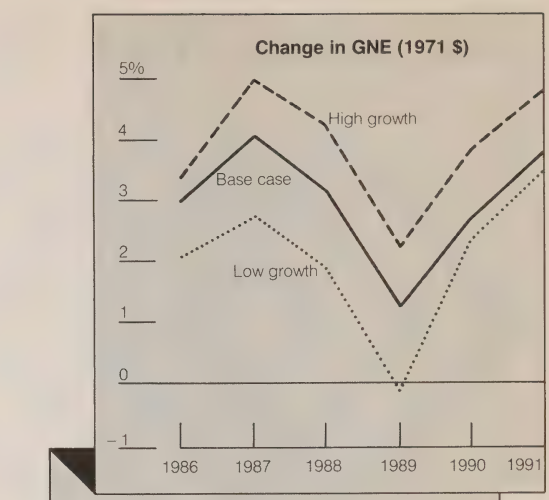
As might be expected, the Council's high-growth scenario indicates a substantially better economic performance for Canada over the medium term. Real economic growth averages 4 per cent a year, and there are marked improvements in the inflation rate and the federal deficit. In contrast, the low-growth scenario lowers economic output, raises unemployment and inflation, and increases the federal deficit.

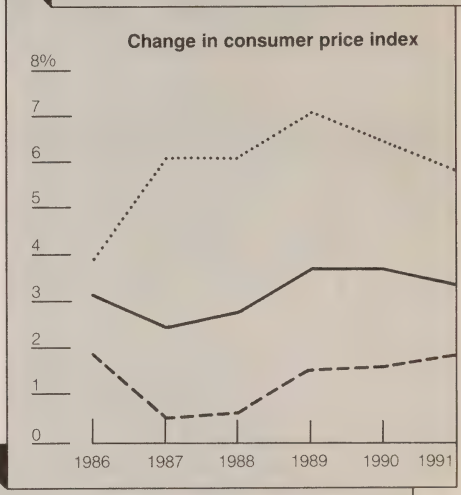
Inflation

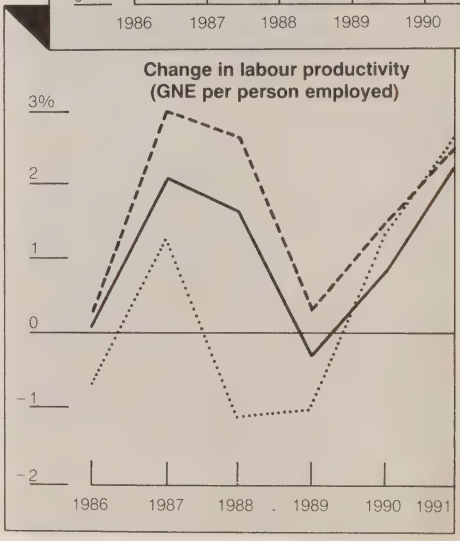
Over the next five years, an unusual combination of favourable factors – the oil-price collapse, weak commodity prices, productivity gains, moderate wage settlements, and continued fiscal restraint – will keep inflation under 4 per cent. Unless monetary growth diverges markedly from its current path, in fact, the Council regards the risks on the inflation front "as being small." As the economy moves towards its potential, however, and as the favourable impact of declining oil prices wanes, inflationary pressures should increase, the Council observes.

Labour productivity

A much better outlook for productivity than in most previous years is permitting substantial gains in real incomes, the Council says. Productivity growth is expected to average 2 per cent a year over the projection period, while real wages will increase at an even stronger rate. The strong performance in productivity is due mainly to a maturing labour force, strong and stable output growth, new technologies, and low real energy prices.







The move to freer trade

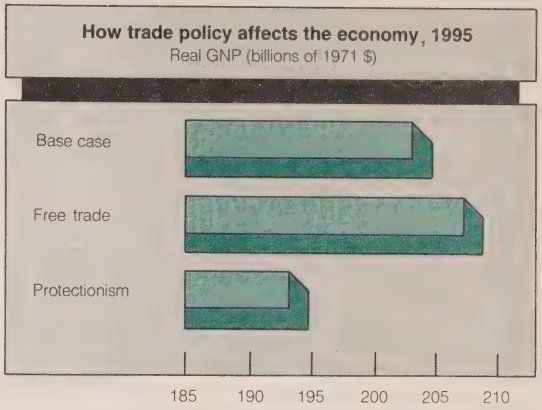
Most Canadians are watching the Canada-U.S. freer-trade negotiations with mixed emotions. In the Council's view, the trade talks will certainly require give-and-take, as well as a firm bottom line on each side of the border. Should a major protectionist confrontation arise, on the other hand, "there would be immense losses for Canada, particularly in employment," it finds.

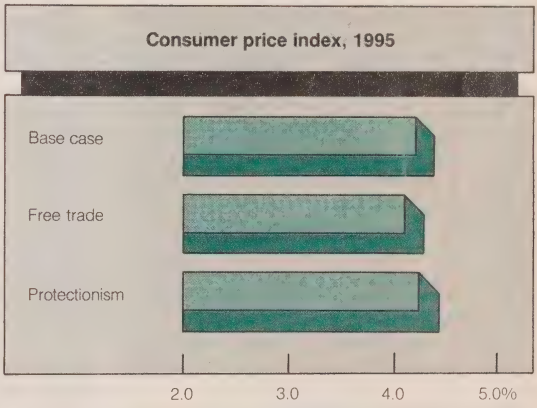
The accompanying charts illustrate the changes likely to occur under freer trade with respect to the Council's base-case projections for three key economic indicators. The Council also attempts to measure the potential long-term gains of trade liberalization – greater economies of scale, product specialization, and so on – by assuming a 5 per cent increase in manufacturing productivity, in combination with freer trade. A variation of this scenario looks at the impact of phasing-in the reductions in trade barriers over the 1987-92 period. A final option looks at the impact of increased protectionism, by assuming a 20 per cent surcharge on most manufactured goods imported from each country, and of retaliation by trading partners.

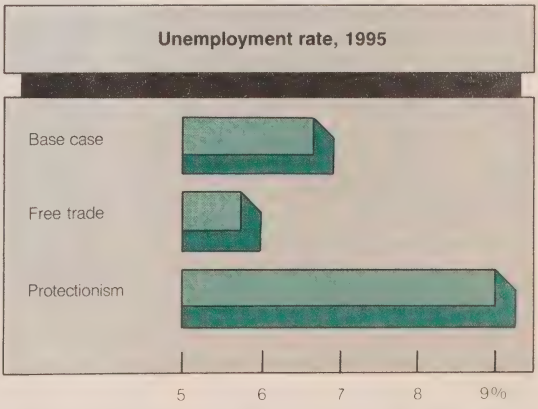
The Canadian economy falters considerably under increased protectionism, as industries adjust to a more restrictive trading environment, the Council finds. Real growth in GNP is 5 per cent below the Council's base-case projection. By 1995, the unemployment rate reaches 2.4 percentage points above the base case, as employment declines by 525,000 jobs. The current-account trade balance worsens, and with declining revenues and rising inflation, the federal fiscal position weakens. Later in the period, inflationary pressures abate, dampened by high unemployment.

Freer trade, on the other hand, is generally beneficial to the Canadian economy, the Council discovers. Indeed, while some of the industries previously protected by high tariffs encounter adjustment problems, all sectors of the economy gain in output – the result of lower inflation, growth in exports, and increased investment and consumption. The unemployment rate dips one percentage point below the base case, while inflation is 2.8 per cent lower. The increase in real economic output attributable to bilateral trade liberalization would be approximately 2 per cent by 1995.

With freer trade and increased productivity, the gain in economic output by 1995 is almost double what it was under the free-trade scenario. As would be expected, the manufacturing sector gains the most. The unemployment rate falls 1.5 percentage points below the base case. Inflation is considerably lower as well. Because of higher import consumption, however, Canada's balance-of-payments situation deteriorates in comparison with the freer-trade scenario. The effect of phasing-in trade barrier reductions over the 1987-92 period would be to cushion and stretch out the adjustment process.







Need for reform in key areas

Governments are re-examining their role in the marketplace in order to keep pace with changing economic times.

While deficit reduction is often cited as the main objective of government reform, the Council believes that fundamental problems in this area run much deeper. New needs and priorities have been emerging; markets have been changing; and new technologies have been developed. Consequently, many of the policy initiatives introduced in the 1960s and 1970s "are no longer in tune with the times," the Council says. In some instances these initiatives hurt the economy, it adds, "because they box people into old ways of thinking and doing."

As part of its ongoing research, the Council has been studying the role of government in various spheres: specifically, the regulation of financial institutions, the reform of social programs and of taxation, and the organization of health care. Undertaking reform in these areas will be particularly difficult, the Council acknowledges, given the opposition to change from vested interests and the reluctance of governments to dislocate workers or taxpayers. But it insists that substantial reform is necessary, noting that the burden of adjustment is in fact widely distributed.

Financial regulation

Shock waves rippled through Canada's financial sector in 1985, as nine financial institutions failed and numerous mergers and acquisitions took place. New financial instruments and practices have emerged in recent years as well, as part of a major reorganization of Canada's financial sector.

Legislation in this area has become increasingly outdated. With the emergence of as-yet-unregulated financial holding companies, for example, the system is governed by what might be called "regulation by looking the other way," the Council says. The regulatory standards of the various federal and provincial bodies whose jurisdiction overlaps in this area also lack uniformity, as do province-to-province regulatory requirements. Also, as new legislation is developed, care must be taken not to limit Canada's opportunities in international markets.

In a forthcoming report on the financial sector, the Council points out that regulatory reform must begin with "a good understanding of the roles of a financial system." It notes that many of the previous studies in this area put forward different, and sometimes contradictory, conclusions and recommendations. The process of regulatory reform must also recognize the trade-offs involved in pursuing various objectives, such as increased competition versus enhanced solvency. It must take a global view of the system, since changes in the Bank Act affect other financial institutions; changes in trust legislation affect the banks; and so on.

> ***Many of the policy initiatives introduced in the 1960s and 1970s are no longer in tune with the times.***

Tax reform

In its bid to introduce major tax reform, the federal government should strive for a system that is more neutral (or even-handed) in its impact on the economy, the Council maintains.

The current corporate tax system distorts investment and impedes economic growth by encouraging certain types of investments over others, it points out. These incentives create a lack of uniformity in the tax system. Tax rates vary enormously, depending on the industry in which the investment takes place; on whether the investment is in machinery, inventories, or buildings; on whether it is financed by debt, new share issues, or retained earnings; and on whether the investor is a household, a tax-exempt institution, or an insurance company. As well, incentives cause a loss in tax revenues, the Council observes.

With respect to recent changes in the corporate tax system, the Council applauds the initiatives taken by the Department of Finance to increase tax neutrality. It also believes that a tax base using corporate cash flow instead of profits warrants careful study.

The manufacturers' sales tax is highly flawed as well, since it, too, varies widely across products and industries. But the plan to replace it with a business transfer tax – which would tax the value added to a product by each firm in the production process – should be explored with caution, the Council warns, since its introduction may require compensating changes in other tax measures. It could exacerbate the bias in the corporate tax that favours investment in machinery and equipment, for example.

Though it is politically and technically difficult, the Council believes that tax reform is vital to improving economic efficiency in Canada. Much can be gleaned from the debate on tax reform in the United States, it adds, since "Canada cannot afford to have tax structures that are so out of line with U.S. alternatives that they discourage this nation's investment effort and economic growth."

Social reform

Mounting pressure to reform social policy is largely the result of the changing industrial structure and the aging of Canada's population, the Council says.

Despite an improving economy, for instance, high unemployment persists. Furthermore, many of the jobs that are being created today offer limited

New publications from the Economic Council

A glimpse of Canada's economic future

Changing Times



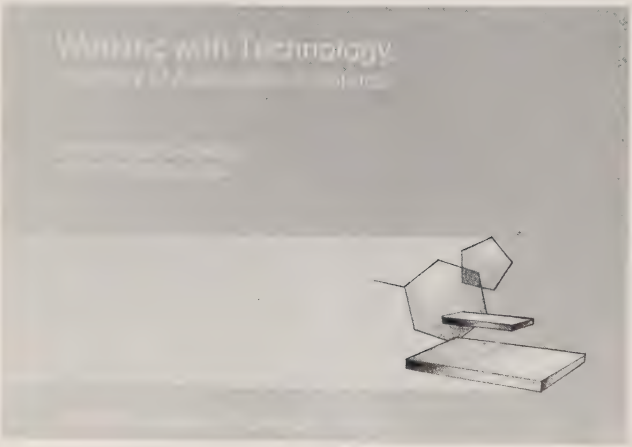
This is the Economic Council's Twenty-Third Annual Review of the economy, which focuses on Canada's economic performance and its opportunities for future growth.

In particular, this year's report looks at the prospect of freer trade with the United States and its impact on output and employment in Canada. It also examines some important policy issues in Canada — the regulation of financial institutions, the reform of the tax system and of the social system, and the organization of health care — since initiatives in these areas would inevitably affect the nation's overall economic performance. As well, it touches on the troublesome issue of resource management, in the areas of agriculture, oil and gas, and the environment.

(EC21-1/1986E; $6.95 in Canada, $8.35 elsewhere.)

Tech change and the job market

Working with Technology



Despite fears to the contrary, technological change is apparently creating as many new jobs as it eliminates.

A new survey by the Economic Council asks employers in a wide range of industries across Canada to describe their experiences with computer-based innovations between 1980 and 1985, and to report on their plans to 1990. Analysis of the responses from close to 1,000 establishments reveals that although job losses to tech change were offset by the new employment generated through increased sales, tech change did lead to new skill requirements. So far, white-collar workers have been the most heavily affected by the new technologies. But blue-collar workers can expect greater changes in their working environment soon, as computer-based innovations in manufacturing processes become more common.

(EC22-133/1986E; $3.95 in Canada, $4.75 elsewhere.)

A guide to new technology

Workable Futures: Notes on Emerging Technologies



Here's one guide to emerging technologies that's more than bland buzzwords and fad gadgetry.

This new Economic Council publication takes the non-specialist behind the scenes to survey arenas of technical growth that are changing the shape of tomorrow. Imaginative and compelling, *Workable Futures* is the indispensable sourcebook for business people, administrators, students, teachers, workers — everyone who wants to understand the opportunities and challenges of today's high-speed technological development. The Council commissioned *Workable Futures* to get at the issues behind the new tech: What's DNA got to do with GNP? What does office automation hold in store for the white-collar workforce? How are working robots creating opportunities for labour in the factory-of-the-future? Find the answers in this new guide to technology.

(EC22-132/1986E; $5.95 in Canada, $7.15 elsewhere.)

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tenure or career-building opportunity. With an ever-growing elderly population, expenditures on public pensions, supplemental income programs, and health care are now rising faster than some measures of economic growth.

The Council is concerned that social programs are not providing assistance to all who need it. In addition, it points to distortions in the economy caused by weaknesses in the funding and delivery of programs (income-tested programs, for example, can discourage workers from seeking employment). The Council offers the government four guidelines for reform: it should be comprehensive, embracing all the tax and transfer programs targeted at a particular group; it should allow for the diverse needs of Canadians, possibly consolidating some of the overlapping programs but not regrouping them into one or two major omnibus systems; it should avoid making large reductions in program expenditures in the first few years; and it should keep in mind that the best social program of all is a healthy and vigorous economy. The Council reiterates its position that "the need for deficit reduction should not be the determining factor in the current review of social policy."

Health care

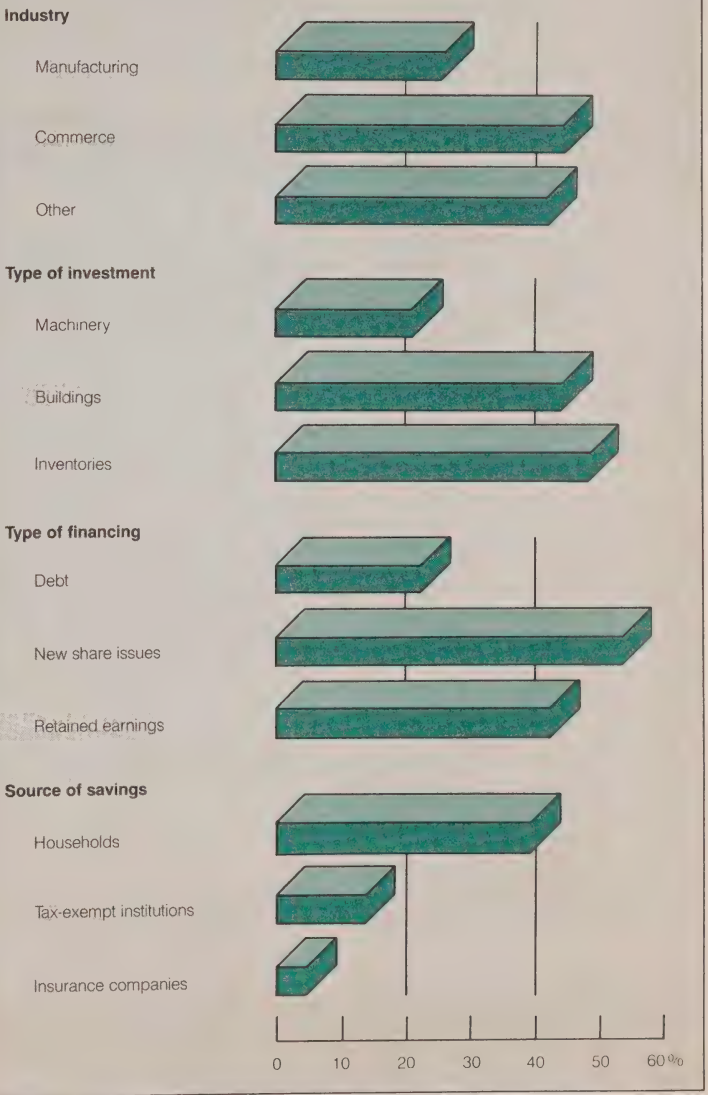
Health care expenditures in Canada have risen dramatically over the past two decades – from $2.1 billion in 1960 to more than $35 billion in 1985. Rising costs are particularly worrisome in light of the growing elderly population. About 2.5 million Canadians have now reached retirement age, and some six million will be there by the year 2026.

The volume of health care services is likely to expand as a result, the Council says. Advances in medical technology will compound the financial problem by prolonging life and easing pain at considerable expense, it points out. Rationing these medical services will make for difficult choices in the future.

While Canada has a first-class health system by world standards – its payment system is a model for other countries, since it effectively controls costs – there are no incentives to manage existing resources wisely, the Council notes. It urges governments and health care professionals to continue experimenting with ways to reduce costs, "always mindful that accessibility and the quality of care are of paramount concern." Progress in this regard includes the possibility of new treatment-oriented accounting procedures that tie health care payments to average treatment costs, based on national or regional statistics. Other proposals now being considered in Canada include imposing tighter control on hospital expenditures, introducing community health clinics, having nurse practitioners compete with physicians where appropriate, and substituting nursing-home care for acute hospital care.

Tax rates vary substantially

Marginal effective tax rates, 1986



Problems in the resource sector

Canada's resource sector is no longer the engine of economic growth that it used to be.

The prices of primary products have slumped badly, forcing many producers to cut back on output in order to curb losses. The Council looks at agriculture and energy in particular, and at the impact of environmental damage on the resource base as a whole.

Energy

In the near term, Alberta will be the hardest hit by the precipitous drop in oil prices. But the current low oil prices are not expected to continue throughout the next decade, it adds.

As for recent moves to reduce government intervention in the oil and gas markets, the Council notes that some important restrictions remain. In the case of oil, long-term exports still require federal approval, while Alberta has a pro-rationing scheme for light-oil production. These factors, along with pipeline capacity limitations, contribute to a discounting of Canadian oil prices in the U.S. market, since Canada is viewed as an insecure supplier.

In the gas market, the key question is whether price deregulation should proceed on schedule this fall. The Council finds that even a partially regulated gas market would create distortions in the energy sector, since it would operate next to a relatively decontrolled oil market and thus could, in the short term, reduce demand for gas in Canada.

Within the industry, the junior oil and gas producers are the most vulnerable to financial hardship, since many of them are financially extended, the Council says. Compared with foreign-owned firms, the Canadian-controlled segment of the industry is on shakier ground because of higher per-unit interest costs, lower per-unit revenues, and higher cost reserves.

Other energy sectors will feel the impact of lower oil prices too, with both positive and negative consequences. At current oil prices, for example, some of the unused capacity in the industrial sector will be harnessed at the expense of other fuels, the Council notes. Electricity costs are expected to fall, however, since coal and oil are inputs to electricity production.

The farmer's plight

The agricultural sector in Canada is in serious trouble. Net farm income declined from $4.3 billion in 1984 to $3.7 billion in 1985. The outlook for the grain sector is particularly bleak because of the likelihood of continuing low export prices.

> *Today, far from being a locomotive of growth, the resource sector is acting as a brake. The emphasis has shifted to damage control.*
>
> — *Changing Times*

High real interest rates and a decline in the value of farm assets are adding to farmers' financial woes, as a result of the widespread debt incurred in the 1970s. (Farm debt rose an average of 16 per cent a year throughout most of that decade.) This created cash flow problems, as farm commodity prices fell sharply in the 1980s, causing a dramatic rise in the number of farm bankruptcies. Drought, soil degradation, and other problems continue to threaten agricultural output. Moreover, the plethora of government programs introduced to ease the burden of debt repayment and to stabilize farm incomes may now come under fire in the context of freer-trade negotiations with the United States.

Environmental issues

The Council is deeply concerned about environmental neglect, since it not only threatens to damage or destroy the resource base, but it also poses risks to human health. At the moment, environmental issues usually surface as crises demanding immediate attention. But they also serve as warnings to put environmental policies in order, the Council notes. It finds some encouraging trends in this regard. For example, many air pollutants have been reduced considerably in recent years. New technologies can better detect and measure toxic substances in the environment. Governments, too, have tightened regulations, particularly with respect to the transport of dangerous goods. Ottawa is soon to announce a major overhaul of environmental law within federal jurisdiction.

Reasons for concern remain, however. About half of Canada's productive forests are threatened by acid rain. Canada is uncovering a legacy of potentially dangerous dump sites. The unlimited or unregulated use of water is no longer feasible. Most of the accessible mature timber stands for use as forest products will be depleted in 60 years. Protecting the environment is costly as well, amounting to as much as 2 per cent of a country's gross national product. To achieve environmental objectives at minimum expense, the "polluter pays" principle makes economic sense, the Council says.

The Council also notes that differences in interests very often prevent joint government action on air, water, and other pollution problems that traverse political boundaries. In particular, Canada must continue to press its pollution concerns with the United States, especially the acid rain problem, the Council says. It also urges other provinces to follow Ontario's lead in cases of environmental abuse, by stiffening enforcement, prosecution, and penalties.

Risks and opportunities

Increased employment and real wage gains should make Canadians more than 10 per cent better-off by 1990, the Economic Council concludes.

That would represent "a significant improvement in economic performance," the Council says. It would also bring Canada closer to the targets set for it by the Council in the past (see box). The economy is moving in that direction, the Council says, after some wrenching adjustments in recent years, which saw an increase in the number of working-age families living in poverty and dramatic growth in the number of women and part-time workers in the labour force. While the adjustment process is far from complete – severe and persistent unemployment has become a disturbing problem in western Canada, for example – there is clear evidence that Canadians are making a serious effort to adapt to the tough economic climate.

Over the medium term, the Council expects Canada to beat the target for inflation, to enjoy significant productivity growth, and to achieve further reductions in the federal deficit, despite the loss of oil-based revenues.

At the same time, the Council identifies three major elements of uncertainty on the international scene that could alter its outlook:

- slower-than-anticipated U.S. growth, linked to higher real interest rates and commodity price pressures, including a new escalation of oil prices;
- heightened U.S. and worldwide protectionism, and the failure of the Canada-U.S. freer-trade negotiations; and
- financial instability and interest rate increases arising from the inability of key countries or institutions to meet their debt burdens.

New opportunities

While the turbulence in the marketplace increases the risks for Canada, it also makes new opportunities possible. On the trade side, manufacturing and service items should continue to grow in importance, while the nation's primary resources remain a mainstay of the economy.

These changes will entail some adjustments, but the Council is confident of solid growth in employment within the manufacturing sector and elsewhere. In the freer-trade talks with the United States, Canada is aiming to eliminate tariff and nontariff barriers, to obtain full exemption from U.S. contingency-liability action against Canadian goods and services and to establish a mechanism for settling bilaterial trade disputes, the Council says.

There is room for change in other areas as well. Governments must revamp many of the outdated regulations in the financial sector, as well as elsewhere in the economy. Part of the long-range solution to fiscal problems lies in reforming the tax system to eliminate tax preferences and to enlarge the tax base. Social reform must be carried out coherently and incrementally, and it should be clearly focused. In health care, controlled experimentation would improve efficiency.

Canada must also redefine its role in the resource sector. Global developments are threatening the viability of the traditional family farm and the programs designed to maintain it. There is no easy or quick solution to this situation, the Council maintains. In the energy sector, the Council supports market pricing and a restructuring of the oil and gas industry to strengthen its debt/equity base. At the same time, "if governments decide that further assistance is appropriate," the Council concludes, the support measures that would be most fruitful would be those which create incentives for further oil exploration and development. In the gas market, while there may be some grounds for temporarily delaying the deregulation of gas prices, on balance the Council favours moving in that direction, since it is the "only way to reduce Canada's surplus reserves of gas over the longer term."

Finally, there is a need in some provinces for more vigorous action to protect the environment and to encourage sound forest management practices.

Fiscal prudence

In responding to these changes, the federal government, in particular, must exercise prudence. While acknowledging that the decline of oil and wheat prices has knocked the federal fiscal plan somewhat off course, "these are setbacks that the federal government must be prepared to absorb," the Council says. Over the medium term, there is scope for a monetary policy that would encourage lower interest rates and stronger economic expansion, it adds.

In commenting on the Annual Review, three members of the Economic Council suggested that more research be done on the effects of freer trade with the United States. They also felt the Review did not sufficiently explore the consequences of failure in the freer-trade negotiations. As well, it did not adequately deal with the problem of unemployment in Canada, they said.

TARGETS

1 — Employment growth of 2 to 3 per cent a year in order to lower unemployment to a range of 6 to 8 per cent by 1990.
2 — Productivity growth of 1.5 to 2.0 per cent a year.
3 — Annual inflation of 5 per cent or less.
4 — Net capital inflows of about 2 per cent of GNE or less.
5 — The maintenance and improvement of existing social policies.
6 — A gradual reduction of the federal deficit to an easily manageable level.

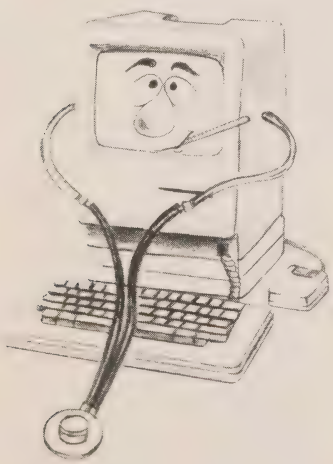
A guide to new technology

The average Canadian may well be baffled (or even intimidated) by the mystifying array of new technologies on today's market. With that in mind, economist Keith Newton (director of the Economic Council's project on tech change and labour markets) and consultants from *Words Associated* have put together a high-tech guide for the non-expert. Entitled *Workable Futures*, the handbook covers topics ranging from artificial intelligence to office automation and includes a glossary of technical terms. Some excerpts from this newly released Council publication are featured below.

Factories on autopilot

The scene: Midnight at a deserted showcase "factory of the future." Inside, the sound of machines in motion, producing parts for tools and robots. Finished trays of parts are automatically stacked and removed for packaging and distribution. Countless details of production, from microprocessors throughout the factory, are relayed to a central computer. The factory operates untended by humans during the nightshift. The lights stay off all night.

Suddenly computer sensors detect a malfunction in one of the automated tools. Within milliseconds, production at this work area or "cell" is halted. A central computer calls the homes of the technicians on duty to request repairs. Suppliers and head office are automatically advised of any changes to the production schedule resulting from the breakdown.



This is the fully automated factory – still largely the stuff of management dreams and labour nightmares. Today, only a few hundred fully automated factories are operating around the world. And, for the time being, most experts expect the factory of the future to remain just that. Introduction costs are high, and paybacks are still uncertain.

But computers, data links, industrial robots, and automated machinery are winning an increasingly central place in industrial production. In the process, they are inspiring a new vision of what manufacturing is all about.

Advanced materials

• An experimental race car screams down the backstretch of a racetrack. At full power its 2-litre engine churns out 318 horsepower, at 9500 rpm. The ultralight engine is made from a new heat-resistant, injection-moldable plastic.

• Respondents to a recent survey conducted by the Canadian Manufacturing Association ranked *advanced industrial materials* as the most interesting of the new technologies.

At the beginning of this decade, plastics replaced metals as the most common industrial material used in North America after wood and concrete. Now, a new generation of plastics and other synthetic materials is poised to alter the material composition of even more products of the industrial system, revolutionizing the way things are designed and made.

Knowledge to go

• Computer: "Question 11. Has patient 219 had symptoms of persistent headache or other abnormal neurological symptoms (dizziness, lethargy, etc.)?" User: "YES."

The computer is running Mycin – the classic "expert system" program developed at Stanford University in the mid-1970s to diagnose blood infections. The program asks the user a series of directed questions about the patient: symptoms, lab test results, and medical history. Answers lead to a qualified diagnosis (in this case, meningitis), usually about as accurate as a human specialist's. After diagnosis, Mycin considers patient weight, allergy history, and other factors to recommend appropriate medication.

Expert systems are the fastest-breaking commercial product in the fast-lane field of computer artificial intelligence. Many successful programs demonstrate that expert systems provide valuable support to human experts in some kinds of problem-solving work. Enthusiasts predict a brave new future for expert systems, as the software becomes more widely available and starts to enter the personal computer market. Some foresee libraries of canned consultants in every business and home – more than a match for problems from auto repair to heart surgery. Insiders caution that present knowledge-processing techniques are still saddled with very severe limitations. Mycin knows a lot about blood diseases. But it has no idea what a "patient" is.

Expert systems organize knowledge acquired from experts and apply it to assist in problem-solving. The inference-procedure component of the program – the logic allowing the computer to arrive at decisions – is quite distinct from the knowledge base or specific expertise. Inference procedures follow a variety of formulas. Mycin, for example, is a "rule-based" system using a "situation-action" or "if-then" line of reasoning to arrive at solutions. A sample rule:

"**If** (i) the infection is meningitis, and (ii) the organisms were not detected by culture colouration, and (iii) the type of infection could be viral, and (iv) the patient is severely burned, **then** it is probable that **Pseudomonas aerugninosa** is one of the organisms responsible for the infection."

New survey on tech change

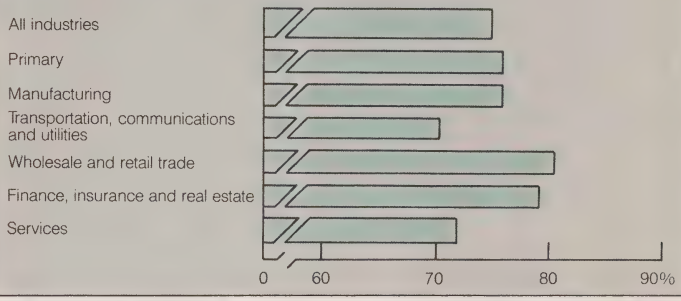
Computer technology is pretty much an established fact in Canadian industry these days, particularly in the case of large companies and U.S. subsidiaries. So far, white-collar workers have been the most heavily affected by the new technologies, since most of these have appeared in the office. But blue-collar workers can probably expect to see greater changes in their working environment soon, as computer-based innovations in manufacturing processes become more common.

This and other information was collected in the course of a new "Working with Technology" survey, conducted by the Economic Council. As part of the Council's study on the labour market implications of technological change (Au Courant, vol. 5, no. 4), economists Gordon Betcherman and Kathryn McMullen asked employers in a wide range of industries across Canada to describe their experiences with computer-based innovations between 1980 and 1985 and to report on their plans to 1990. Using the responses from close to 1,000 establishments, they catalogued the new technologies that were reported and described the employment and organizational changes that accompanied the innovations. (A detailed analysis of these findings will be made available at a later date). Highlights from the survey include the following:

- Three-quarters of the organizations surveyed reported the introduction of some computer technology during the first half of the 1980s.
- Large companies and those with foreign parents (particularly from the United States) were the biggest innovators. Regionally, western Canada had the highest rate, followed by Quebec and Ontario, and finally, the Atlantic provinces.
- Wholesale trade; communications and utilities; and business services had particularly high innovation rates (see top chart).
- In general, the employment record of the innovators was neither better nor worse than that of the non-innovators, as indicated by the fact that their employment growth was about the same over the five-year period (see bottom chart). Any job dislocation resulting from the innovating process, the authors explain, was apparently offset by new employment, generated through increased sales. Tech change did, however, lead to new skill requirements, which were usually met by retraining existing workers through short-term, on-the-job programs.
- Wages were consistently higher in innovating organizations for all the occupations surveyed. Wage gains were greater too, having increased 40 per cent on average for innovators and 32 per cent for non-innovators.
- Almost two-thirds of the technological changes introduced were relatively inexpensive office innovations, such as word processors, personal computers, and office networks. The dominance of office over production-process automation (such as robots in factories and automated parts warehouses) – as well as the stronger performance of large firms over small ones – can be explained in part by the very high cost of process automation technologies, the authors suggest.

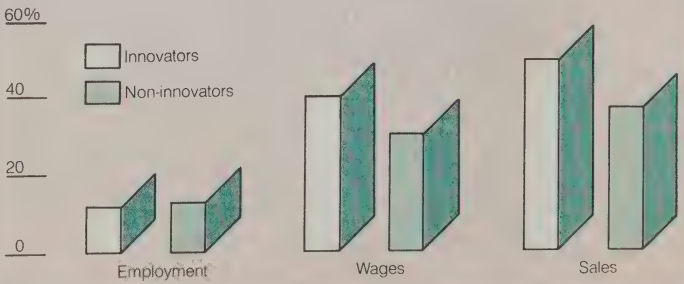
Industries and innovators

Percentage of establishments reporting computer-based technological change, 1980-85



Innovators and non-innovators: jobs, wages and sales

Percentage change in full-time employment, wages and sales, 1980-85 (based on establishment medians)



S·P·E·A·K·I·N·G · O·U·T

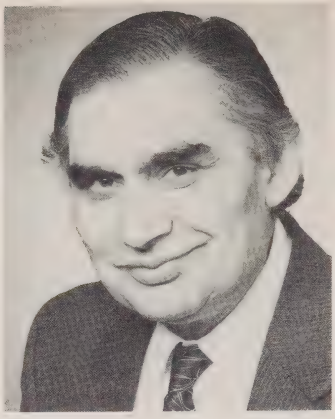
As a major trading nation, Canada is always on the lookout for new export opportunities.

But the prospect of freer trade with the United States, as well as further trade liberalization under the General Agreement on Tariffs and Trade (GATT), presents both opportunities and risks for Canada. Fewer bilateral and multilateral trading restrictions would be a boon to some Canadian industries, but the spectre of industrial dislocations and job layoffs in other sectors of the economy is a cause for some concern. The Economic Council looks at both sides of the equation in a new project examining trade-policy options and structural adjustment in Canada. To find out more about this undertaking, *Au Courant* interviewed project director Sunder Magun.

Au Courant: *Why is the Council undertaking this project?*

Magun: Since nearly a quarter of all the output in Canada is exported, trade represents a large part of the economy. So it is important to know how this sector will adjust to bilateral and multilateral trade liberalization, in order to assess the kind of industrial adjustment policies that might be needed and to help the country design better bargaining strategies for entering trade negotiations with other countries.

Part of the project involves simulating the impact of a freer-trade agreement with the United States and the subsequent impact on investment flows between the two countries. We shall also measure the effects of the tariff reductions that have occurred under the GATT framework, as well as the likely impact of further cuts that are expected to follow the next round of GATT negotiations. In this regard, the project will study the process and speed of industrial adjustment in Canada by estimating the output and employment effects of trade liberalization – by province, by industry, and by occupation.



Sunder Magun

Au Courant: *Have there been any preliminary findings?*

Magun: Yes. Using the Council's CANDIDE econometric model, we have found that trade liberalization with the United States is beneficial for Canada. The output of the economy increases, and in many sectors employment goes up. But we are not yet at the stage in our analysis where we can pinpoint, in precise terms, the gainers and the losers with respect to who will benefit or suffer as a result of trade liberalization. Later on we expect to have some answers, since we will be studying 40 Canadian industries and 80 occupational groups in detail.

Au Courant: *Will your information be useful in terms of the current Canada-U.S. trade talks?*

Magun: Yes. We intend to release the analyses and the supporting information as they become available. Right now we are focusing exclusively on the Canada-U.S. trade initiative, though, as I mentioned earlier, some of our research will be helpful in the GATT negotiations. In both respects it is worth noting that the Council is raising a number of questions that have not been asked before.

For example, there has been no research into the extent of nontariff trade barriers that exist between Canada and the United States and the effect on trade flows of removing such barriers. At this point we are working with various U.N. agencies to compile a first-ever list of those barriers in Canada and other major industrial countries.

A second area where we are breaking new ground is in our examination of the impact of trade liberalization on investment flows. At present, the bulk of Canada-U.S. investment activity is conducted through Canadian and U.S. multinational firms. Therefore it is crucial to have some idea of how these firms will respond to freer trade. Finally, there has been very little research in the area of structural adjustment on an industry-by-industry basis. The difficulty of identifying the gainers and the losers in the move to freer trade, both in the short run and in the long run, is still with us. We intend to examine this issue in detail. The results will provide the background information needed to help Canada restructure existing manpower, regional, and industrial programs, as well as design new, specially targeted measures.

Au Courant: *But what about the arguments we hear from the various interest groups who either support or oppose freer trade on the basis of their own research?*

Magun: I do not think that any detailed study to date has come up with reliable results insofar as identifying the impact of freer trade on specific industries, occupations, or communities. One thing is for sure: some industries will be affected positively and some negatively. We should also keep in mind that Canada will undergo greater structural adjustment than the United States, since our economy is more protected than theirs (Canadian tariff rates are higher, for example), and our exports to the United States account for about three-quarters of our total trade.

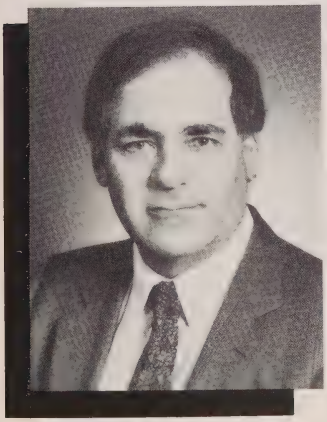
Au Courant: *What happens if there is a breakdown in the Canada-U.S. trade talks?*

Magun: I would say there are two possibilities. First, the Americans may decide, after leaving the bargaining table, to become more protectionist. Canada would lose considerably in that case. The second scenario is that, upon failure of the talks, Canada would return to its traditional approach of liberalizing trade with the United States through the GATT framework, which it has been doing for some 30 years. This approach would be much more time-consuming, however, since there are so many other countries involved. Furthermore, the GATT negotiations have, in the past, had little success in controlling nontariff barriers, which pose the largest threat to Canada-U.S. trade. Indeed, in recent months our access to the U.S. market has become increasingly uncertain with the application of U.S. anti-dumping laws, the imposition of countervailing duties on Canadian exports, and other forms of contingency protection. This situation is particularly worrisome, not only because it affects Canadian exporters but also because it discourages those forms of investment in Canada which depend on access to the U.S. market. For example, many Canadian investors are establishing plants in the United States, in order to avoid the nontariff barriers. At the same time, investors whose businesses in Canada require access to the U.S. market are now more reluctant to invest in such things as new technology and human resource development. Essentially we are losing investment to the United States.

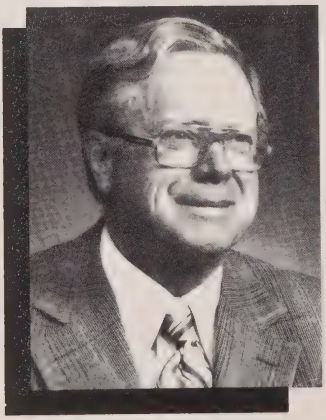
Au-Courant: *How important are the GATT negotiations to Canada?*

Magun: We consider these negotiations as complementary to the U.S. talks. There is considerable scope for expanding our trade with other countries, particularly in the Asia-Pacific region. In the next GATT round, Canada will be searching for ways to help restore greater discipline and openness to the existing multilateral trading environment. We will also be stressing the benefits of removing trade barriers against agricultural and forest products, transport and communications equipment, nonferrous metals, petrochemical goods, and services. Canada, incidentally, is supporting the development of rules for regulating trade in services, which offers tremendous potential to Canadian exporters.

New members appointed to the Economic Council



Raymond Koskie is a partner in the law firm of Koskie and Minsky in Toronto, Ontario, and a past partner of Robins and Robins. He has acted as legal counsel to trade unions and is a specialist in the field of Employee Benefit Plans.



Raymond Nelson is president of Nelson Lumber Company in Lloydminster, Alberta. He is also a director of a number of Canadian companies, including Alberta Energy Company Ltd. and British Columbia Forest Products Limited.

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Over the past two decades, the Council has focused on public policy issues of key importance to Canadians — including economic growth, the role of new technology, the impact of government regulation and the changing job market, to name only a few.

The Council pursues its goal of improving Canada's economic performance in three ways:

Consultation

Members of the Council, representing a wide cross-section of Canadian society, meet regularly with governments and groups to study, analyse, and make recommendations on significant economic issues.

Research

An expert staff originates research and provides background information on a variety of topics, with particular stress on the medium- and longer-term problems of the Canadian economy.

Information

The need for better information on economic issues has led the Council to place strong emphasis on its contact with the public, through the use of topical publications, speeches, conferences, workshops and media relations.

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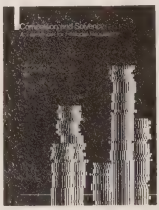


Reforming the financial sector
A new look at government enterprise

PUBLICATIONS

New Council Statement

Competition and Solvency: A Framework for Financial Regulation (EC22-134/1986E; \$4.95 in Canada, \$5.95 elsewhere).



In this statement, the Council puts forward a new framework for financial legislation, on the grounds that the existing regulatory system has not kept pace with changes in the marketplace. The statement also looks at such issues as ownership; conflict of interest; consumer protection; various institutional practices; and the need to harmonize financial regulation among provinces and different regulatory agencies and between the federal and provincial governments. (The recommendations in this statement are based on the findings of a research report to be released shortly by the Council.)

New Council Report

Minding the Public's Business (EC22-135/1986E; \$10.95 in Canada, \$13.15 elsewhere).

The Council looks at the role of government enterprise in this report. It develops a general framework for the evaluation of public enterprise and applies it in the examination of a number of federal, provincial, and municipal corporations. The case studies lead to some important recommendations. At a more general level, the report puts forward suggestions for improving the management and control of public corporations, and provides guidelines for determining under what circumstances they are the most appropriate policy instrument.

Reprint

The following Council publication has been reprinted and can be ordered in accordance with the information below:

Workable Futures: Notes on Emerging Technologies, by *Words Associated* and *Keith Newton* (EC22-132/1986E; \$5.95 in Canada, \$7.15 elsewhere).

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the personal responsibility of the author or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 314 "Marginal effective tax rates for the oil industry in Alberta, 1965-84," by *Mireille Ethier* and *Dominique Simard*.

No. 315 "Structural change and regulatory reform in rail transport: Opportunities for separating the ownership of track and carriage," by *Adil Cubukgil*.

No. 316 "Structural change in employment of industries and occupations, 1971-81: An input-output analysis," by *Garnett Picot* and *Laval Lavallée*.

How to order

Research studies and Council reports are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion Papers, *Au Courant* and the *Annual Report* are available without charge from the Information Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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industry. The Council also believes that share offerings should be made initially only to Canadians.

As for rail freight, the Council feels that the industry would be more efficient and more productive if competition within the industry were increased. It notes that the provision of rail-freight services does not require heavy capital investment and is inherently competitive; therefore these services should be open to anyone (including shippers) willing and able to provide them. As such, the Council proposes that new firms be allowed entry into the rail-freight carriage business and that they be provided with liberal access to the existing roadbed.

To help increase rail-freight competition, the Council suggests the establishment of a public track authority based on the CN infrastructure. All potential carriers would apply to this new authority to provide a specified service on the "public track." The authority would be concerned only with maintaining and managing the track; all other activities would remain with CN, which would not necessarily have to remain a public company.

Passenger rail

While VIA Rail was created largely because of public concern over rising passenger-rail subsidies, its own operating losses have continued to mount. Of particular concern to the Council are VIA's lack of a proper legislative mandate and the arrangements governing its purchase of passenger-rail services from CN and CP (payments to the two railways account for two-thirds of VIA's operating expenses).

Current arrangements allow the railways essentially to pass on their costs to VIA, without giving them any incentive to improve their efficiency.

Legislation had been introduced in the last session of Parliament to provide VIA with a mandate; to allow more generally for clarification of the government's passenger-rail-policy objectives; and to give VIA more leverage in its dealings with CN and CP. The Council supports this legislation but would increase the authority of VIA's board of directors. It also believes that VIA should seriously consider competitive tendering to help it reduce its current dependence on the railways.

Air Canada should be sold through a broad share offering made initially only to Canadians.

Industrial policy

Canadian governments have frequently used government enterprise as part of their overall industrial-policy strategy. In some cases, a public enterprise was established to help correct perceived capital-market inadequacies. In other cases, the aim was to establish a Canadian presence in a given sector (usually a high-tech one). And still other government enterprises were set up – usually in high-unemployment regions – to prevent the closure of a private firm and thus maintain employment.

Although there have been exceptions, the Council finds the performance of all three types of public enterprise generally quite disappointing. For example, the Canada Development Corporation, created in response to a perceived lack of capital for homegrown Canadian enterprise, has had a poor record as finder and developer of profitable Canadian businesses; indeed, it has earned a far lower rate of return over the past decade than has the average Canadian industrial firm.

While government enterprise may be unavoidable in the case of a "bail-out" of the failing private firm, the Council believes it should be viewed as an instrument of last resort. As the experience of enterprises like Cape Breton Development Corporation illustrates, political pressure may make it very difficult for government to withdraw support from such enterprises, no matter how costly they may have become. To reduce the costs associated with government enterprise in these cases, the Council suggests that it be accompanied by appropriate adjustment measures, such as worker retraining and relocation programs, and industrial restructuring.

Mixed enterprises – in which both private and public interests own equity – play a limited role at best, the Council says, because the government's public-policy aims may clash with the interests of private shareholders.

Nonrenewable resources

Canadian governments have become involved in the nonrenewable resource sector for a variety of reasons: to keep more of the proceeds from such resources within a particular jurisdiction, to ensure adequate energy supplies, and to promote economic development. The Council finds that while public enterprise has sometimes been a useful way to achieve those objectives, many public resource enterprises were the product of particular historical or political circumstances that no longer apply. "In general," the Council suggests, "(such) objectives are more appropriately pursued through alternative instruments."

In the case of Petro-Canada, the Council says there are significant costs to maintaining a major commercial enterprise within the public sector. For example, since Petro-Canada's equity is not publicly traded, the impact of its purchase of Petrofina could not be reflected by investor reaction to that purchase. As well, government resources are better devoted to carrying out public-policy objectives than to administering commercial activities. The Council believes that Petro-Canada's objective of developing nonconventional energy sources and its concern with security of supply could be addressed more effectively through other policy instruments. Hence it recommends that Petro-Canada be privatized and that share offerings be made initially only to Canadians.



Controlling government enterprise

Many Crown corporations are difficult to manage because corporate objectives are unclear and because managers lack sufficient freedom of action.

In order to make these firms properly accountable, governments should give them "real authority and responsibility," along with a clear statement of objectives, the Council maintains. The problems of controlling government enterprise have received considerable attention lately, as a growing number of reports and inquiries disclose the dismal state of financial management control in many Crown corporations. While significant reforms have been introduced in recent years, many problems remain.

Among the principal difficulties in controlling public enterprise, the Council finds that governments often lack the information necessary to do a proper job. In particular, governments may rely on available financial data that tend not to be very meaningful, partly because these corporations have noncommercial obligations that are difficult to assess in financial terms. In many cases the most serious problem is the lack of precise corporate objectives against which to measure the company's performance. Moreover, the ministers and government officials to whom corporate managers report may not be effectively accountable for actions that influence the decisions of these managers.

Needed reforms

In response to these problems, the Council suggests a number of reforms. A major requirement, it says, is for a "more rational division of responsibilities" between governments and the boards of public corporations. It therefore proposes that, for each corporation, governments be required to table in the legislature a statement of objectives (and/or any changes to it), which would clearly identify all imposed public obligations and make them a matter of public record. The statement would serve as a guide to management and as a basis for assessing corporate performance. It would also help to resolve any conflicts between the company's commercial and noncommercial activities. Each statement would be reviewed periodically and would undergo a major re-evaluation every three to five years.

Corporate boards

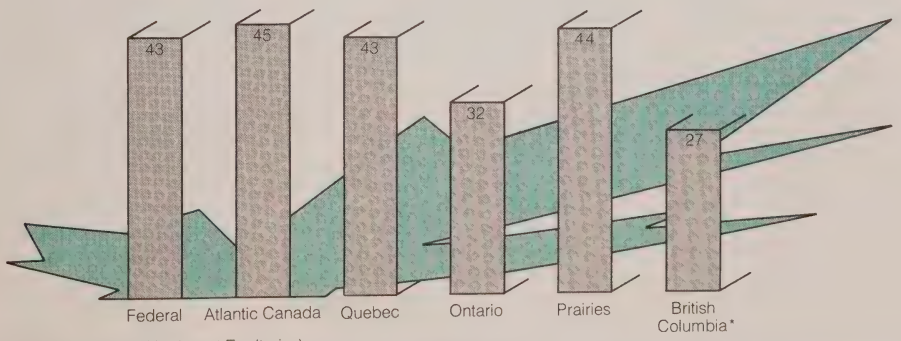
While ministers must provide the required policy direction, responsibility for the administration of corporate activities "should properly fall to the board of directors," the Council insists. To strengthen the position of the board, it proposes that directors be appointed from among candidates nominated by an independent commission, that ministers or public servants from the parent government be excluded as members, and that final authority over the hiring and compensation of senior management belong to it. To attract skilled and experienced board candidates, directors' fees should be brought more in line with private-sector rates. Finally, public corporations should be subject to the same legal responsibilities as private firms under the Canada Business Corporations Act, and these responsibilities should be linked to the statement of objectives.

Investment decisions

As a further measure to minimize ministerial involvement in corporate decision making, the Council would require a separate agency of government to assess and approve all commercial investment decisions by public corporations. Within government this would help to avoid situations where the individuals involved in the initial investment decision have subsequent monitoring responsibility. The Council believes that noncom-

Sizing up government enterprise

Number of wholly owned Crown corporations, federal and provincial, 1985



*(including Yukon, Northwest Territories)

mercial investments, on the other hand, warrant increased attention by policy makers.

Monitoring and evaluation

The Council recommends that a thorough evaluation be undertaken prior to the creation of a public corporation or the establishing of a new objective for an existing one, with particular attention to the costs involved (including such hidden costs as a below-market return on capital investments). The evaluation would attempt to weigh the competing claims on the government's budget and consider alternative instruments for achieving the desired objectives.

Measures are needed, the Council says, to make sure corporate officials appropriately represent the public interest. Where possible, for example, the corporation's performance should be assessed against that of a private company engaged in the same activity. Since the corporation's financial performance may at times be an inadequate monitoring tool, a detailed examination of its corporate activities may be necessary, the Council points out. Finally, since rewards and penalties can pressure management to perform better, corporate boards should be allowed the flexibility to tailor employee compensation packages to meet their specific needs.

Holding corporations

While holding companies may serve a useful purpose in some situations, generally they do not increase corporate accountability or improve governments' control over public enterprise, the Council finds. Since they are set up to control other enterprises, in fact, holding companies encroach on the role of directors of these enterprises. The Council would rather see stronger boards within each corporation.

Legislative committees

Federal and provincial legislatures have an important function in the control process in overseeing the activities of government enterprise. To improve legislative surveillance, the Council suggests greater use of specialized legislative committees. (The 28 standing committees recently established at the federal level would be well suited for this task, the Council notes.) Committee members should be appointed for the life of the legislature so they can develop knowledge and expertise in a particular subject area. The committees themselves must have sufficient budgets to hire competent professional staff. They should also be given complete access to available information and should be able to summon government and corporate officials during investigations. (When sensitive information is to be discussed, these investigations should be held "in camera.")

The role of auditors

Federal and provincial auditors are helpful in monitoring government enterprise, but their methods and the criteria used in comprehensive auditing should be open to criticism and debate, the Council says. Moreover, auditors' findings should be interpreted in the light of management explanations and in relation to the alternative evidence gathered by the relevant government or legislative committee.

Mixed enterprises

In the coming years governments may turn increasingly to the use of "mixed enterprises" – wherein they share ownership with private investors – as a convenient halfway house on the road to privatization. In these instances, governments should not have powers greater than those of other shareholders under federal or provincial corporate law. The Council does suggest, however, that a special group within government be set up to monitor the performance of mixed enterprises.

Subsidiaries

Many public corporations have authority under their enabling legislation to establish subsidiaries, or at least they are not precluded from doing so. In some cases the subsidiary is free from the reporting requirements of its parent and may have greater powers as well. In the Council's view, however, corporations should not be allowed to create or acquire a subsidiary without explicit Cabinet approval. (New federal legislation makes this stipulation.) As well, the mandate and powers of the subsidiary should not be greater than those of its parent, and control mechanisms should apply equally to both.

As for government-enterprise monopolies such as the provincial hydro utilities, the Council proposes that regulatory commissions be assigned a major responsibility for monitoring and controlling them.

Significant costs will be incurred unless the process of privatization is handled carefully.

Legal status

Most federal and provincial government enterprises have special privileges and immunities, such as exemption from criminal prosecution and other laws. The majority of provincial government enterprises do not pay corporate income tax either. The Council questions the granting of special immunities and privileges, since it is contrary to the principle of equality before the law. It suggests that governments, as a start, accept in principle "the desirability of removing current immunities limiting the taxation of public corporations."

Privatization

Public enterprise will remain an important policy instrument in Canada despite the growing debate over privatization, the Council concludes. But as governments increasingly consider selling some of their holdings, the Council warns that significant costs will be incurred unless the process of privatization is handled carefully. For example, attaching conditions to the sale – such as the requirement to undertake research and development – may severely reduce the earnings, and thus the market value, of the corporation. It also notes that where shares are to be broadly distributed, the government should initially issue a small offering, in order to gauge investor reaction and establish some basis for setting the share price in subsequent offerings.

The environment revisited

Governments are becoming less credible in their role as environmental watchdogs.

One reason is that persistent reassurances about environmental safety – proffered in response to the growing spate of recent environmental disasters – are "beginning to wear thin," says Peter H. Pearse of the University of British Columbia, a Canadian authority on the environment and chairman of the recent Inquiry on Federal Water Policy. Public anxiety about the safety of the environment continues to swell over the unknown effects of such incidents as the Chernobyl nuclear accident and the discovery of chemical pollution at the bottom of Ontario's St. Clair River.

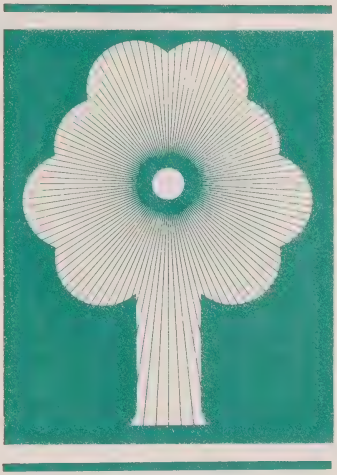
"The public is beginning to realize that we don't live in a risk-free environment," Pearse says. "But risk is always a matter of degree."

Because Canadians are becoming steadily more conscious of their environment, public policy will be influenced "more and more by the need to minimize risks to the environment and human health," he explains.

Pearse was responding to questions by *Au Courant* in a follow-up to its coverage of the Economic Council's Colloquium on the Environment, held in Toronto just over a year ago. The Colloquium brought together more than 100 experts to discuss some of the major environmental problems facing Canada and other countries. (The papers presented at the Colloquium have been published by the Council under the title, *Managing the Legacy: Proceedings of a Colloquium on the Environment*.)

Asked to identify what he believes to be Canada's most pressing environmental concern, Pearse cited the growing use and presence of persistent toxic substances – those which resist biological or chemical transformation. "The fact that we don't know how to dispose of a growing number of toxic substances is very worrisome to say the least," he says. "We are pressing on the limits of our scientific knowledge."

While biotechnology offers some hope of solving the toxic-waste problem – by developing bacteria to consume these wastes, for example – the appearance of toxic substances in the environment is growing at an alarming rate, Pearse notes. Although not all chemicals are toxic, about 32,000 are being used in Canada today. As many as 800 toxic organic substances have been found in the waters of the Great Lakes, according to the latest studies. In Ontario alone, about half



a million tons of hazardous industrial wastes are being disposed of improperly each year. Often these include many of the most toxic and difficult-to-treat substances. Nowhere in Canada, in fact, does there exist an approved treatment facility for such poisonous pollutants as PCB compounds, which are becoming increasingly detectable in virtually every form of life. (Ontario recently approved the technology for the province's first mobile PCB destruction unit.)

Canadians are demanding more effective control of these pollutants, Pearse says, as evidenced in part by their growing preference for such commodities as bottled water and by their concern over the use of pesticides in food production and forestry. (In a recent poll, in fact, many Canadians indicated their willingness to forgo economic development in order to protect the environment.) At the moment, however, legislation fails to provide sufficient means of coping with the toxic-waste problem, Pearse maintains.

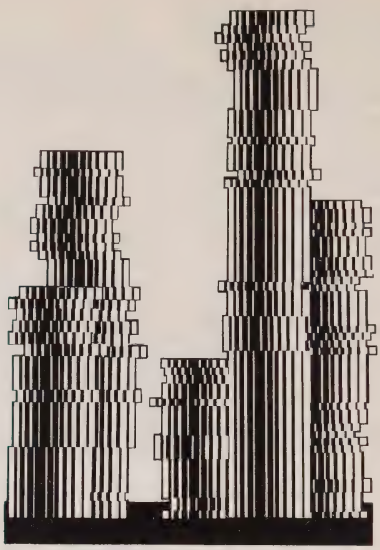
What is needed, he suggests, is a "cradle-to-grave" approach that would ensure that toxic substances are registered and approved before being allowed on the market. (Ottawa is adopting the idea in its new Environmental Protection Act.) Their use should also be strictly regulated, possibly by a toxic-control commission modeled on the lines of the Atomic Energy Control Board, he says.

But the major impediments to effective pollution control are the problems created by the division of powers between Ottawa and the provinces. Many of the activities that threaten the water system, for example – including mining, forestry, and municipal works – come under provincial jurisdiction. But the federal government administers the Fisheries Act and its environmental safety provisions. Environmental legislation at both levels is weakened by the absence of cooperative arrangements for controlling pollution that crosses provincial or international boundaries. A major breakthrough in this regard came last fall when federal and provincial environment ministers agreed to new water-quality guidelines.

Meanwhile, most governments' economic portfolios continue to operate apart from their environmental agencies, which are usually accorded "junior status," Pearse says. At the same time, an emerging view is developing that "sustainable economic development is clearly dependent on a healthy environment," he points out.

If Canada has failed to make significant progress on some pollution fronts, however, it has made impressive headway in tackling more traditional pollution problems, Pearse acknowledges. Because of stricter regulation, for example, wastes discharged by the pulp and paper industry have in some instances been cut in half since the late 1960s.

Competition and Solvency



Canada needs sweeping changes to its financial system in order to boost competition and enhance solvency in that sector, says the Economic Council of Canada.

In a new statement containing 31 recommendations, the Council says that weaknesses in the existing regulatory framework are "so severe that fundamental reform has become imperative." (These recommendations are based on the findings of a research report soon to be published by the Council.) Many of the problems in this area stem from the breakdown in the traditional division of functions among chartered banks, trust companies, insurance companies, and securities firms. Today it is possible to buy stocks from a bank; to open a demand deposit account (a classic banking function) with an investment dealer; to purchase short-term deferred annuities from a life insurance company; and so on. Yet, despite the growing overlap in many of their products and services, regulation (of each of the pillars) of the financial system has not adapted to the new realities.

In its new statement, *Competition and Solvency: A Framework for Financial Regulation*, the Council concludes that regulators have either had inadequate power or have not used the existing powers to deal with the recent onslaught of financial-sector difficulties. The turbulence of the past few years – most notably the failure of 22 financial institutions between 1980 and 1985, the instances of abuses, and the quest for diversification – has also raised some important questions. Is it prudent to combine banking and insurance, or commercial lending and securities underwriting, for example? Is it wise to combine financial and nonfinancial companies under one corporate umbrella? What is the impact on competition of increased concentration of ownership in the financial sector? Is there an increased potential for abuses? The growing complexity and globalization of financial markets are creating additional competitive pressures, while an antiquated domestic regulatory framework sometimes makes it harder for Canadian firms to meet the international competition head on.

The Council points out that the regulatory system does not provide a "level playing field" in its application of the rules to the various financial players. Banks, for example, are the only deposit-taking institution required to hold non-interest-bearing reserves against deposits. In addition, the overlap in regulation creates confusion and has become an increasingly serious administrative burden. Deposit-taking, for example, is subject to regulation by the federal Inspector General of Banks, the federal Department of Insurance, the Canada Deposit Insurance Corporation, and various provincial regulatory bodies.

The lack of harmonization in provincial policies and practices also impedes the efficiency of the financial system, the Council points out. In some cases it would appear that provinces compete against one another in order to attract financial business. Access to financial services in many communities is quite limited, and there are barriers to competition, in the form of heavy start-up costs in retail banking and capitalization requirements, various incorporation and licensing requirements, and so on.

There is now a broad consensus on the need for reform, the Council says, since a sound and efficient financial system is of vital importance to the Canadian economy. The Council favours adopting a new regulatory framework that would "give full play to competition and at the same time buttress the solvency of institutions." The proposed framework would result in better service to Canadians at lower cost. The changes would require governments to harmonize legislation – and some institutions to undergo internal adaptation – "but they are not radical," the Council insists.

"We believe the proposed adjustments are worthwhile ... in the context of a system that would be better able to finance Canada's economic growth, to build world-class financial institutions that can compete on international markets, and to safeguard the soundness and solvency of institutions upon which Canadians rely," the Council concludes.

A framework for reform

In the Council's view, the basic thrust of reform should be to strike the best balance between increased competition, enhanced solvency, and adequate consumer protection and accessibility. Reform should also be forward-looking, in order to keep pace with the accelerating changes in the marketplace. As well, the cost of regulation should be minimized, in terms of both its administration and its impact on the normal course of financial business. (Nonetheless, regulators should be given sufficient resources to do the job properly, the Council adds.)

A new framework

With that in mind, the Council recommends a "regulation-by-function" approach to the reform of the Canadian financial system. This would provide for a "level playing field." Because solvency is an institutional matter, under the Council's new framework, each institution would be restricted to engaging in one major financial "function" – banking or insurance, for example. An institution could also diversify into other financial functions by creating a holding company authorized to acquire other types of financial institutions. A separate regulatory authority would be responsible for each function. Regulators would determine the range of permissible activities under each function, based on what they, and the companies involved, considered prudent. For example, commercial lending might not be an appropriate activity for securities dealers who underwrite new stock issues, given the potential for conflict of interest.

Whether or not it is part of a holding group, each institution could engage in such activities as "networking" and "cross-selling" – promoting and selling another institution's products – provided those arrangements do not make combined purchases compulsory. Members of a financial holding group could, within limits set by the relevant regulator, sell assets and lend funds to one another without prior regulatory approval, provided the members are not in any financial difficulty. Each institution would have to maintain a separate capital base to ensure greater solvency. The Council also suggests monitoring the financial health of holding groups and including a requirement for global financial statements on a quarterly basis.

Banking definition

Each financial function would have to be well defined, the Council asserts, in order to have effective regulation by function and to ensure that each function is supported by a separate capital base. One of the most difficult tasks in this regard would be to reach agreement on a definition of banking, since so many financial institutions are engaged in banking activities. The Council proposes that any institution be considered a bank if it is involved in providing "means of payment" – such as deposits that can be withdrawn on demand or transferred by cheque.



Canadian Bankers Association

Banking activities would be defined

This new definition would bring under federal control the deposit-taking activities of some institutions that are now provincially regulated. But it would not centralize the regulatory apparatus to any significant degree. Through the creation of a new category of cooperative bank that recognizes the special local nature of provincially regulated financial cooperatives – credit unions and caisses populaires – only the central organizations of these cooperatives would fall under the Bank Act. Federally incorporated trust and loan companies already account for 80 per cent of the total assets of these businesses, the Council points out. Also, the federal government could delegate to a province supervisory responsibility over institutions that operate within that province only, it suggests.

Costs and benefits

Financial cooperatives and trust companies would be affected the most by the proposed changes, and particularly by their new obligation to hold non-interest-bearing reserves against deposits. (This cost would be lower if interest were paid on reserves.) Life insurance companies and other institutions that offer depositlike instruments (short-term deferred annuities, for example) would either have to modify those instruments or spin off a banking subsidiary to deliver them from within a holding group. The separation of banking and trust services would occur at the production level only, so that trust companies could continue to use their existing retail networks to deliver any number of services. The deposit-taking side of the trust business would gain by acquiring the powers of a bank.

Notwithstanding the costs, the primary advantage of the new system is its simplicity, the Council says. It would eliminate the current regulatory overlap and the lack of clarity in the sharing of responsibilities between Ottawa and the provinces. Regulators would be able to do a better job, because they would be responsible for only one major function. Institutions, for their part, would have "great flexibility in meeting the various financial requirements of their clients," by using the holding-company route to diversify into other financial functions. Firms would not be tied to the holding-group structure in order to diversify at the retail level, however, since any institution could enter networking agreements. The new system also recognizes the special nature of financial cooperatives. Finally, the system is forward-looking, since the definition of a financial function can be changed over time.

Urgency of reform

The Council realizes that sufficient time is needed for institutions and governments to adapt to, and implement, the new system. But because of the urgency of reform, governments should proceed "as expeditiously as possible" to amend all financial legislation, the Council maintains.

The legislative review should be carried out simultaneously, since changes in one law can affect institutions other than the one under consideration. A full legislative review should be undertaken periodically as well, so that changes in the marketplace do not force regulators to become legislators (by having to regulate or leave unregulated new financial practices that are not covered under existing legislation, for example). The Council suggests including "sunset clauses" in financial legislation for that purpose.

To strengthen regulatory capacity, the Council would grant regulators more power to monitor and enforce legal provisions; to establish a better early-warning system, so that preventive measures to ensure solvency could be undertaken at an early stage; and to require that regulatory authorities alert one another to any problems encountered by member institutions of financial holding groups. Finally, the Council urges provincial governments to implement mechanisms that would ensure interprovincial uniformity of financial regulation.

The new look financial system

Current System	Council Proposal
1. Banking function performed by banks, trust companies, loan companies, credit unions, caisses populaires, etc.	1. Separate institutions — banks, insurance companies, securities dealers, etc. — for each function.
2. Institutions are attempting to enter new fields of activity.	2. Institutions allowed to diversify through holding groups.
3. A variety of federal and provincial regulators for each function, particularly banking.	3. One regulator responsible for one function only, making regulation simpler, more efficient.
4. Networking arrangements — for example, a bank selling life insurance — prohibited under some laws.	4. Local branches of any institution allowed to participate in networking arrangements.

Toward a healthier system

New conflict-of-interest rules, well-defined ownership limits, better corporate governance, and greater consumer protection would make for a healthier financial system, the Council maintains.

Measures in these areas are key to preventing "harmful transactions that endanger the solvency of institutions or the fair treatment of customers," it says. In particular, the Council recognizes that allowing financial institutions to diversify through holding groups increases the potential for harmful "non-arm's-length" transactions (where related parties do business). On the other hand, some non-arm's-length transactions can be beneficial, since they give holding groups increased flexibility – to reallocate funds in order to take advantage of the most profitable opportunities, for example.

Preventing abuses

To help distinguish between harmful and appropriate non-arm's-length transactions, the Council would require financial institutions to establish a special committee of their board of directors to review all major non-arm's-length activity. The committee would be composed mostly of outsiders to the firm and would have the authority to reject or reverse a decision not deemed to be in the interests of minority shareholders, depositors, or other customers. Financial institutions would also be required to disclose to their customers any major conflict-of-interest situations in which they might find themselves. The relevant regulators would monitor such disclosures.

As a further precaution against harmful non-arm's-length transactions, the Council would ban loans to company directors and managers, or to any shareholder owning more than 10 per cent of the company's outstanding voting shares.

The Council is concerned about the possibility of financial institutions straining their finances by bailing out associated nonfinancial companies. So it would prohibit financial holding groups from acquiring nonfinancial subsidiaries (unless those firms are providing related services, such as data processing).

To prevent an excessive concentration of ownership in the financial sector, the Council would limit any one company or individual from owning more than 10 per cent of the capital stock of an independent financial institution or a group of related institutions with more than $10 billion in domestic assets. (The $10-billion cutoff is designed to balance the benefits of hands-on management for smaller firms against the higher costs of abuses for larger firms. Owners of institutions with more than $10 billion in assets at the time the rules are implemented would not have to divest but would be required to dilute their holdings as the firm grows.) Individual firms whose combined assets exceed the $10-billion mark could not be owned by any one company or individual either. In any event, the purchase of more than 10 per cent of the capital stock of a financial institution would be subject to prior regulatory approval.

The limits on ownership, the Council explains, would be applied at the highest level, so that individual firms within a holding group could be "closely held" – owned by a small number of individuals – provided the holding group met the ownership requirements. The Council recommends, in fact, that institutions linked through a holding group be wholly owned by the holding company, unless at least 35 per cent of their voting shares are widely held by other investors. Minority shareholders would be better protected as a result, the Council says.

As for foreign companies, they would be allowed to enter all financial sectors gradually, provided Canadian firms are given the same rights in their home countries. In Canada, foreign firms would be subject to the same regulations as domestic firms.



Protecting consumers' interests.

Royal Bank of Canada

Institutional practices

The Council's investigation also indicates that certain institutional and management practices need reforming. Under existing legislation, for example, auditors' obligations are "vague and incomplete," it finds. Their role should be clarified, requiring them (and actuaries, where applicable) to report to regulators any material wrongdoing they uncover or any serious concerns they might have about the solvency of the companies they audit. Internal audit committees should be strengthened as well. Since auditors need management's full co-operation to do a proper job, the latter should be liable for the quality of information provided auditors.

The rules governing how financial institutions invest their funds are too restrictive and should be revised in consultation with the institutions themselves, the Council says. To ensure solvency, however, each institution would have to maintain a separate capital base. In calculating the size of its capital base, each firm would have to deduct any holding of more than 10 per cent of the common stock or subordinated debt that it has acquired in another financial institution. (Regulators use the size of an institution's capital base to determine, among other things, how much it can lend.)

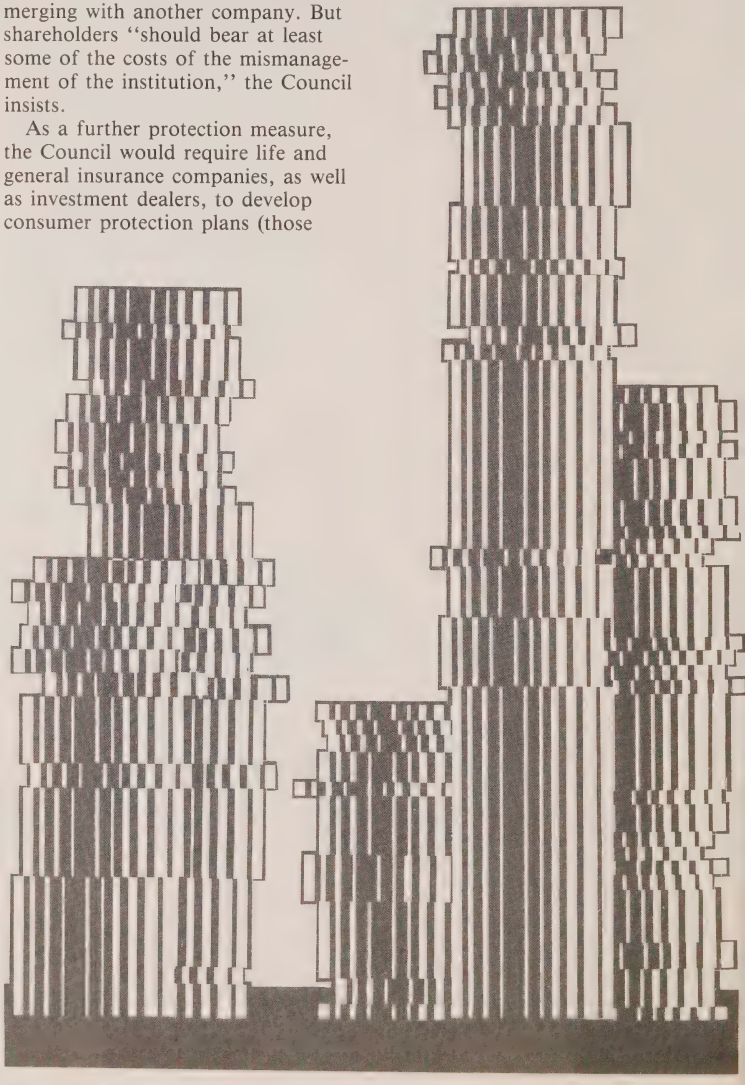
Consumer protection

In the context of a fast-changing financial world, public confidence in the financial system and consumer protection are of "paramount importance," the Council says. The existing insurance coverage on deposits of up to $60,000 should be maintained by the Canada Deposit Insurance Corporation (CDIC), it concludes. But more generous limits should apply to deposits that form part of a registered retirement savings plan. Since the CDIC ultimately pays when financial failures occur, it should share supervisory power with the federal regulator of banks. It should also have the power to set insurance premiums, the Council says.

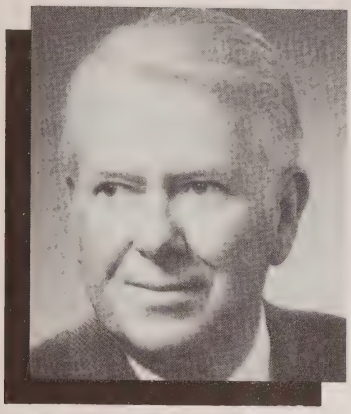
As a general rule, the Council believes that governments should not provide a guarantee to uninsured depositors. When financial disaster looms, governments might consider a takeover or assistance to the firm in merging with another company. But shareholders "should bear at least some of the costs of the mismanagement of the institution," the Council insists.

As a further protection measure, the Council would require life and general insurance companies, as well as investment dealers, to develop consumer protection plans (those already in place should be strengthened and well publicized). Financial planners and investment counsellors, together with lawyers handling estate and trust accounts, would also have to meet minimum standards under a licensing agreement. Finally, any institution delivering in one transaction two products that originated in separate institutions would be obliged to inform customers of their option to buy the second product from other distributors. This would reinforce consumers' awareness of their sovereignty in the marketplace, the Council says.

Public confidence in the financial system and consumer protection are of paramount importance.



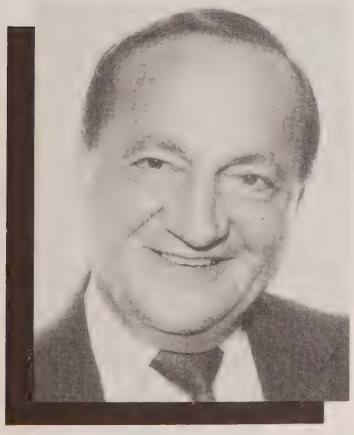
New members appointed to the Economic Council



Chester Johnson is chairman of the B.C. Hydro and Power Authority in Vancouver, as well as director of a number of companies, including B.C. Place Ltd., the Prudential Assurance Co. Ltd., and Scott Paper. He is also a member of the Faculty of Commerce and Business Administration Advisory Council at the University of British Columbia.



Chaviva Hosek is a research partner with Gordon Capital Corporation in Toronto and president of Pensionfund Immunization Inc. A former professor of English at the University of Toronto (Victoria College), she is also past-president of the National Action Committee on the Status of Women.



Steve Atanas Stavro is the president and owner of Knob Hill Farms Ltd. and of Sevendon Holdings Ltd. The founder of the Steve Atanas Charitable Foundation, he is also a member of the board of directors of the Better Business Bureau of Metropolitan Toronto and of Maple Leaf Gardens Ltd.



Graham Wilson, of Hamilton, Ontario, is vice-president and corporate secretary of Dofasco Inc. He is also president and chairman of the Board of Management of the Hamilton Art Gallery, and director of the National Ballet of Toronto.

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Economic Council of Canada

Volume 7, No. 4, 1987

Road map for tax reform



Focus on agriculture

The changing job market

PUBLICATIONS

New Council Statement

Road Map for Tax Reform: The Taxation of Savings and Investment (EC22-136/1987E; $4.95 in Canada, $5.95 elsewhere).

In this Statement, the Council analyses the major taxes on incomes, property, and resources in Canada, and puts forward recommendations designed to make the tax system more efficient in these areas. The Council argues that the existing system prevents the economy from performing to its potential, by impairing the rate of capital formation and by encouraging investments in projects that are attractive only because of their favourable tax treatment.

New Council Report

A Framework for Financial Regulation (EC22-137/1987E; $8.95 in Canada, $10.75 elsewhere).

This research report provides the detailed analytical findings that support the Council's Statement on financial institutions published last November. It takes an indepth look at the regulation of financial institutions; the sharing of responsibilities between the federal and provincial governments; and such issues as self-dealing, conflict of interest, and consumer protection.

Reprints

The following Council publications have been reprinted and can be ordered in accordance with the information below:

Working with Technology: A Survey of Automation in Canada, by *Gordon Betcherman* and *Kathryn McMullen* (EC22-133/1986E, $3.95 in Canada, $4.75 elsewhere).

Workable Futures: Notes on Emerging Technologies, by *Words Associated* and *Keith Newton* (EC22-132/1986E; $5.95 in Canada, $7.15 elsewhere).

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No. 317 "The economic effects of the property tax: A Survey," by *P. Hobson*.

No. 318 "Taxes and indebtedness of Canadian corporations," by *J.-M. Gagnon*, *J.-M. Suret*, and *J. St-Pierre*.

No. 319 "Assessment and fiscal treatment of imputed rents for homeowners-occupiers," by *R.-P. Domingue*.

No. 320 "The welfare effects of property taxation in an open economy," by *S. Damus*, *P. Hobson*, and *W. Thirsk*.

No. 321 "On calculating marginal tax rates from stock-market prices," by *J.-M. Gagnon*, *J.-M. Suret*, and *D. Morissette*.

No. 322 "Évaluation et traitement fiscal des rentes imputées aux propriétaires-occupants," by *R.-P. Domingue*.

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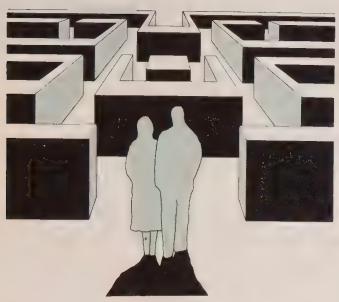
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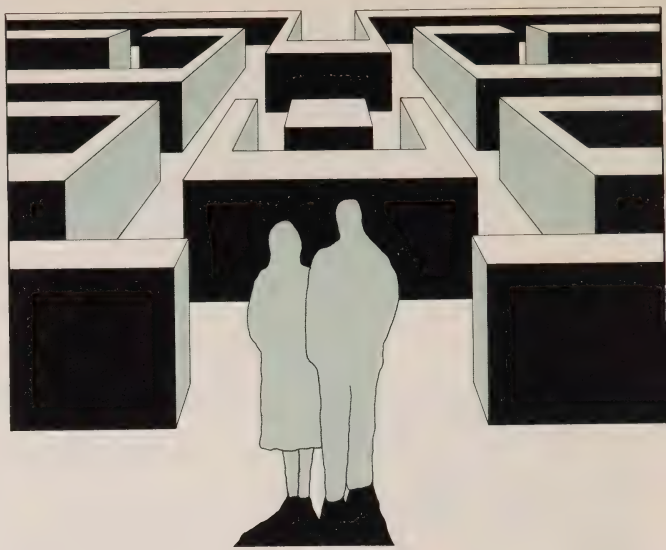
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Editor: *Barbara S. Campbell*

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Road Map for Tax Reform



Canadian living standards would be much higher, and some tax rates lower, under changes to the tax system proposed by the Economic Council of Canada.

In a new Statement on taxation, the Council says there is broad consensus on the need for tax reform. Governments are concerned about the tax system because it fails to generate enough revenue despite the relatively high statutory tax rates. Citizens are upset because they perceive the system as being too complex and unfair. Businesses are critical of the complexity, the high statutory tax rates, the uneven tax treatment of different investment projects, and the changes that are constantly being made to the system. Consensus also exists on the need to broaden the tax base by eliminating tax preferences so that statutory rates can be reduced. (The consensus does not include agreement on specific measures, however.)

The proposals put forward in the *Road Map for Tax Reform* are based on a three-year research program examining the taxation of capital income (income from savings and investment). The project is one of the largest research programs on taxation undertaken outside the federal Department of Finance since the Carter Royal Commission of the 1960s. (Detailed findings of the project will be published this spring.) The Council decided to focus on the taxation of capital income primarily because of its profound impact on national output and living standards. The analysis takes account of all levels of government and of the major types of taxes on income, sales, resources, and property.

The Council places two restrictions on its inquiry that are particularly important: its proposals are not designed to change the total amount of tax revenue that governments now collect; nor are they intended to change the overall distribution of income that results from the current tax system. Instead, the Council concentrates on the question of tax structure. It examines how the tax system affects the efficiency of the Canadian economy and living standards in Canada through its impact on saving and investment decisions, and what changes in the tax structure would increase output and living standards over time.

The Council finds that the existing tax system prevents the economy from performing at its potential, largely by impairing the rate of capital formation and by encouraging investments in projects that are attractive only because of their favourable tax treatment. A key aim of the Council's recommendations is to put similar investments – and the choice between saving and consumption – on the same footing for tax purposes. This would encourage people to make saving and investment decisions based on economic returns rather than on tax considerations.

The Council's road map puts forward two main themes for tax reform: on the corporate side, it opts for a broader definition of taxable income and lower tax rates, while generating the same amount of revenue; on the personal side, it also opts for base broadening and lower rates but at the same time proposes a longer time horizon for taxation, so that individuals would have more scope for averaging their incomes over their lifetimes, and so that they would pay the same tax whether they spend now or later. What all this means for Canadians in general is that they would not be discouraged from saving for a car, a house, and for retirement; they would have an easier time filling out their tax returns; they would pay no more taxes than anyone else in a similar income situation; and they would have larger incomes. Furthermore, says the Council, "working Canadians would benefit the most."

In developing its recommendations, the Council was guided by the belief that tax reform should address three main issues: the choice of appropriate principles for taxation or the selection of tax bases; the breadth of the tax bases chosen; and the mix of taxes used to generate the government's revenue needs. It also believes that a good tax system should be assessed in the light of several criteria, including its efficiency, fairness, simplicity, stability over time, and the extent to which it encourages government accountability in a democratic society. Using these principles, the Council puts forward recommendations for policy change in five key areas – personal taxes, corporate taxes, the sales tax, property taxes, and resource taxes.

What are the problems?

Canada's tax system tends to discourage saving, thwart economically sound investment decisions, and violate the basics of a good tax system, the Council argues.

Tax rates on capital income vary enormously, depending on the industry, asset, mode of finance, and tax status of the investors involved. These variations in tax treatment, the Council says, "turn economic losers into tax winners." The complexity of the system is reflected in the fact that almost 40 per cent of federal taxpayers now have their personal-income-tax returns completed by others. Furthermore, abrupt changes in tax laws (over 100 pages of amendments to the Income Tax Act, "even in a dull year," says one tax practitioner) can cause economic dislocation, create windfall gains and losses, and lower the rate of capital formation. Finally, while taxes should be visible to increase government accountability in a democratic society, some taxes, such as the federal manufacturers' sales tax, are largely hidden from the public.

The Council is convinced that "taxes as they are now structured are a barrier to efficiency and to higher standards of living because they needlessly distort decisions by investors, savers, consumers, and producers." As part of its research, the Council documents some of the major shortcomings of the present tax system.

Personal income tax

The different tax rates on various savings and investment opportunities can encourage people to choose one investment over another. These decisions may not be the most economically efficient, the Council finds. It notes as well that inadequate indexing for inflation can lead to hidden tax increases. Moreover, unless the corporate and personal income taxes are integrated, shareholders are subject to "double taxation" – that is, corporations are taxed on their earnings, and shareholders are taxed again when they realize those earnings in the form of dividends and capital gains.

Furthermore, under an annual-income-tax system, the taxation of savings – first as part of income, then on the subsequent flow of returns – discourages saving and encourages immediate consumption. This in turn reduces the amount of savings available for investment and generally raises the cost of capital. The taxation of annual income thus discourages saving for future consumption (in retirement, for example). In the absence of averaging provisions, annual income taxation also treats people with a variable income less favourably than those with a regular income. That's because the former have to save in order to smooth out their consumption patterns over periods that can exceed one tax year (and are liable to be taxed on those savings).

Corporate income tax

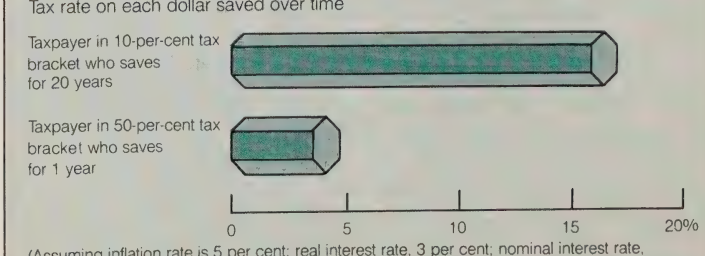
The corporate income tax is riddled with a variety of tax credits, allowances, and deductions, with the result that some activities are taxed much more heavily than others. In any given year, in fact, about half the corporations in Canada pay no tax at all. Among the principal corporate-income-tax provisions that distort the system are the investment tax credit (now being phased out); accelerated depreciation allowances for machinery (which allow businesses to write off new equipment against their tax liabilities at a faster rate than for other investments); the unfavourable tax treatment afforded equity-financed, as opposed to debt-financed, investments; preferential tax rates for manufacturing and processing firms, as well as for small businesses; and the lack of integration of corporate and personal income taxes. As a result of these incentives, tax rates for new investment in 1985 varied from as much as 102 per cent to as little as a subsidy of 78 per cent, the Council reports.

Other taxes

The federal manufacturers' sales tax introduces major distortions because it is applied unevenly on goods and services. It taxes some inputs used in the production of certain goods and hence has different effects on the final prices of goods. Provincial sales taxes share the same problems. Property taxes discriminate against businesses in favour of residential property owners. Taxation in the resource sector also varies widely and is complicated by provincial royalty arrangements (whereby firms pay for the right to extract natural resources); exploration, development, and processing allowances; and the competing claims and responsibilities of the federal and provincial governments.

All told, these variations in tax rates on capital income "exact a heavy toll in terms of Canada's productivity performance," the Council concludes. It asks whether the system can be modified "in ways that will encourage more efficient business decisions and increased prosperity."

How the tax system discriminates against saving



(Assuming inflation rate is 5 per cent; real interest rate, 3 per cent; nominal interest rate, 8 per cent)

Proposals for reform

In its bid to introduce major reform, the federal government should strive for a tax system that is more neutral (or even-handed) in its impact on the economy, the Council says.

The Council believes that its tax reform package would move the system in that direction, thereby making it simpler, fairer, and more efficient. The average incomes of Canadians would rise, and some tax rates would fall, even though governments would collect the same amount of revenue.

Personal income tax

The main thrust of the Council's recommendations in this area is to nudge the system toward a "lifetime-income tax" – which would not discriminate against saving and would allow taxpayers more scope to average their incomes over their lifetimes. The idea behind the Council's proposal is that those who save now should be given the same tax treatment as those who spend now. This would do two things: it would enhance efficiency by removing distortions in the current tax base through a more neutral treatment of different types of savings and investment and of consumption over time; and it would give taxpayers greater freedom to manage their own affairs by taxing them at a marginal rate corresponding more closely to their lifetime incomes.

The Council has six recommendations for accomplishing this goal. First, it suggests phasing out the $500,000 lifetime exemption for "capital gains" – the profit made when an asset is sold for more than its purchase cost – and taxing that income in full (excluding capital gains on principal residences and the current treatment of family farms). Conversely, taxpayers should be allowed full deductibility for capital losses. Overall, this proposal would simplify the tax system substantially by treating capital gains like other income. It would also broaden the tax base and open up the possibility of reducing top marginal rates.

Lower rates

To compensate for the full taxation of capital gains and still leave the distribution of tax burdens unchanged, the Council recommends that the top federal marginal tax rate on personal income be reduced from 34 to 30 per cent and that the next highest bracket be reduced from 30 to 28 per cent. It would directly affect about 3 per cent of tax filers annually and could be made without exhausting the revenue earned from taxing capital gains in full.

Registered saving

The Council regards tax provisions for registered saving (such as registered pension plans and RRSPs) as a "convenient do-it-yourself income-averaging device enabling individuals to smooth out their lifetime tax payments" (because contributions to such registered savings are deductible from taxable income, while withdrawals are taxable). The Council opts for removing the dollar limits on the amounts contributed to registered savings. As circumstances permit, the contribution rate should be increased to a level ranging from 25 to 30 per cent, and it should be total income that qualifies for the contribution rather than employment earnings only, as is now the case.

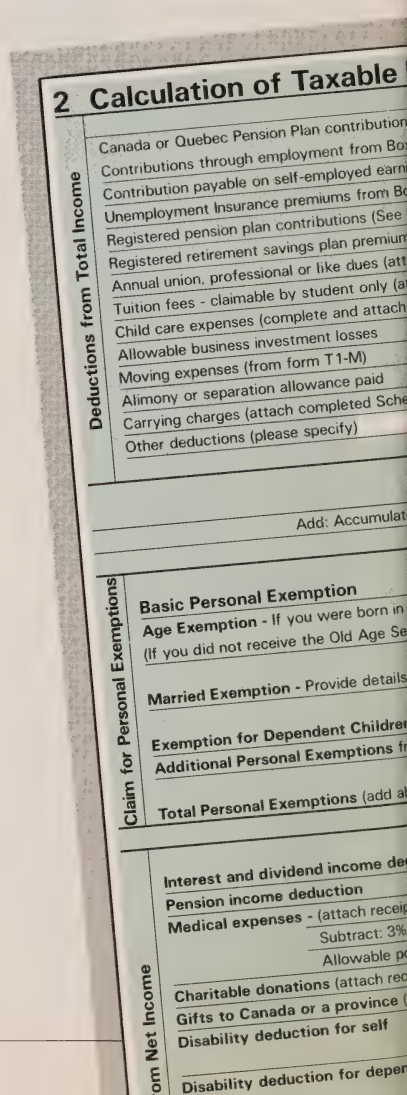
For most taxpayers, a significant amount of saving is done through the purchase of durables, such as houses. But if taxpayers were to use registered savings to buy a house, for example, they could be overtaxed on the withdrawals (because they could end up in a higher tax bracket). So the Council believes more provision should be made for nonregistered savings that are tax-exempt. It suggests doubling the current $1,000 deduction for interest and dividends, and including net rental income and taxable capital gains in that deduction, which should be indexed.

Registered borrowing

The Council also suggests introducing registered borrowing as a means of assisting a wider range of individuals through the tax system. In this way, a taxpayer who, for some reason, is experiencing a period of lower income could declare a loan as taxable income and then deduct the interest and amortization payments on that loan later on when his or her income increased. People who want to leave the labour force temporarily for reasons such as retraining would be eligible to benefit from this scheme.

Indexation

In the past, high inflation rates have created some of the greatest dis-


2 Calculation of Taxable

Deductions from Total Income

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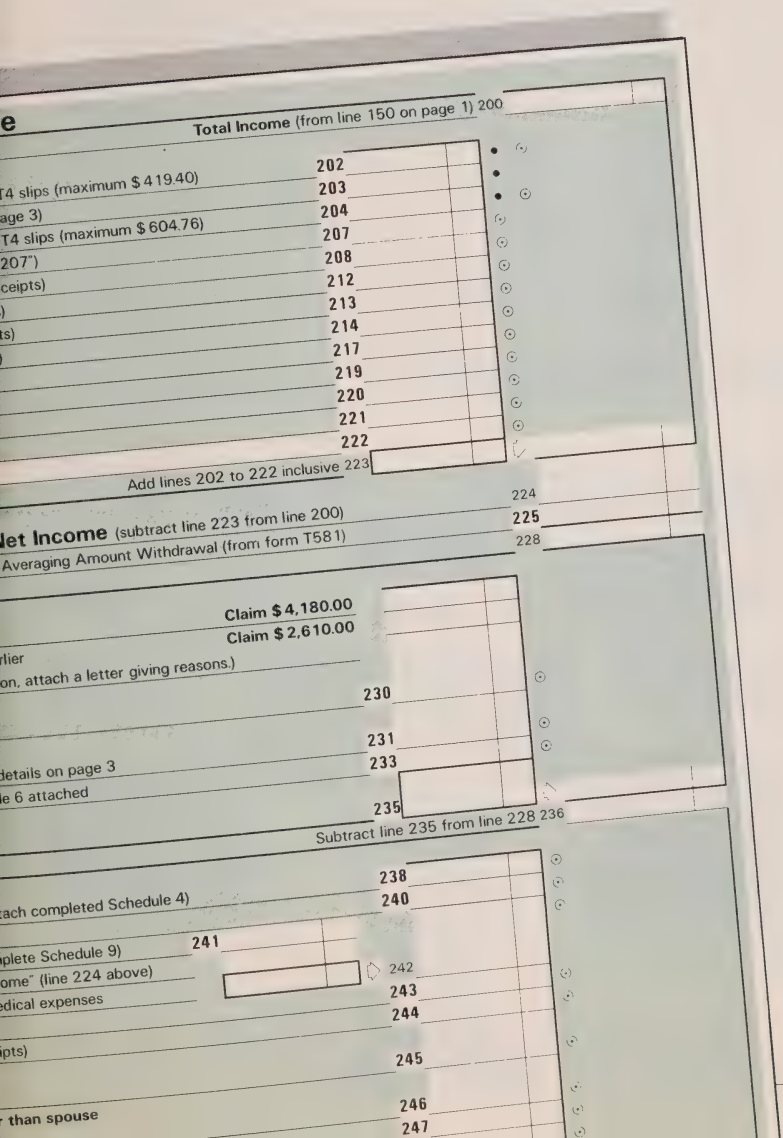
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tortions in the tax system because of the lack of full indexation. Inflation has also increased government tax revenue beyond any legislated tax increases. Last year the federal government limited the indexing of the personal income tax to amounts in excess of a 3 per cent increase in the cost of living. In the Council's view, however, the government should, as a minimum, restore indexation at the full inflation rate for all relevant personal brackets, deductions, and exemptions. The proposed enlargement of registered savings programs would also reduce the need for what could be a complicated form of indexation of capital income.

Corporate income tax

The Council believes it is possible to achieve a much greater degree of tax neutrality by broadening the corporate-income-tax base and by cutting statutory tax rates. The Council also supports the government's recent decision to phase out the investment tax credit for all but a few special types of investments.



Capital cost allowances

Accelerated capital cost allowances allow firms to write off the cost of certain investments long before the end of their economic lives. This leads to a wide variation in tax rates among assets, firms, and industries. Consequently, the Council recommends having these allowances correspond more closely to actual capital costs, taking account of physical wear and tear, obsolescence, and the current cost of replacing an asset.

Indexation

The corporate-income-tax system should continue to compensate for inflation, the Council maintains. Such compensation would involve an across-the-board increase in capital cost allowances and the provision of a uniform inventory allowance. These allowances would constitute a rough approximation of indexation for the corporate sector as a whole, as long as inflation remained below 5 per cent. At the same time, as a medium-term objective, the Council suggests developing a fully indexed scheme along the lines proposed by the Ontario Committee on Inflation Accounting. This contingency scheme, the Council says, could take effect if inflation remained above 5 per cent for a prolonged period.

Uniform rates

Steps should be taken to ensure that statutory corporate-tax rates are more uniform across industries and different types of activities. More precisely, the deduction for manufacturing and processing firms should be abolished, and a combined federal and provincial statutory tax rate of 33-1/3 per cent should be adopted. In this way, statutory tax rates in the manufacturing sector would be no higher than at present, the Council points out. For Canadian-owned small businesses, the first $200,000 of business income should be taxed at the rate of 25 per cent.

Tax bias

The Council says reforms are needed to eliminate the tax-induced bias against the investment of registered savings in common shares. This bias results from the loss of dividend tax credits when shares are held in registered pension plans and RRSPs. To remedy this, the Council

suggests creating a separate "capital component account" within registered savings plans that would make dividend earnings eligible for the dividend tax credit at 33-1/3 per cent upon withdrawal (as well as treating capital gains in the same manner).

Loss offsetting

Under the present system, many firms are unable to take advantage of all the tax allowances for which they qualify. Almost half the investment undertaken in Canada between 1977 and 1981, for example, was done by companies that were rarely able to use their capital cost allowances, investment tax credits, and other deductions. Although these deductions or tax losses can be carried forward (or backward), the period over which they can be spread is limited. Moreover, these tax allowances lose value over time, since companies forgo interest on the losses carried forward. In the Council's view, companies should be allowed to carry forward losses indefinitely – with interest – subject to appropriate tax-avoidance rules.

Sales taxes

Sales tax reform – federal and provincial – must aim at a reduction, or elimination, of the variation in tax rates across commodities, and at the removal of sales taxes on business inputs (materials and capital goods, for example). The Council favours replacing the federal manufacturers' sales tax with a broadly based, uniform "value-added" tax – which would tax the value added to a product at each stage in the production process. The federal government's planned business transfer tax is expected to take this form. The Council supports its introduction, provided that the new tax is imposed at uniform rates, with as few exemptions of consumption goods and services as possible. It also encourages provincial governments to remove business inputs from the base of provincial sales taxes and recommends that both levels of government discuss simultaneous reform of their sales tax systems.

The Council is concerned about the hidden nature of the proposed business transfer tax, so it suggests having it invoiced separately or posted at the cash register to make it visible at the point of sale. In addition, the Council recommends that those with incomes below a stipulated threshold be given a sales tax credit. For a variety of reasons, the Council also warns against using the business transfer tax to generate substantial increases in federal tax revenue.

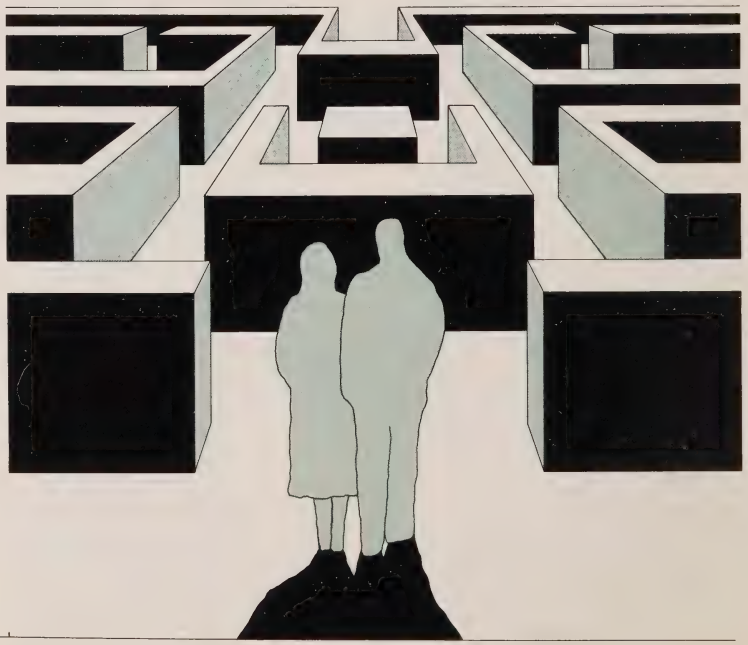
Resource Taxes

In this area, the Council reiterates its position that some incentives and fiscal burdens affecting resource development should be removed from the tax system. While endorsing the deduction of exploration expenses from taxable income, it recommends the gradual withdrawal of the remaining federal earned depletion allowances and provincial processing allowances. Their removal would be offset by a general reduction in federal and provincial tax rates. Given the current state of the market in the mining sector, however, these allowances could be phased out gradually. Unused depletion allowances should be allowed to be carried forward with the same interest as on losses carried forward.

Furthermore, the Council would like to see a return to the system whereby provincial royalties are fully deductible from income taxable by the federal government. At the moment, companies are taxed by the federal government on income that includes royalties and other provincial resource payments. To compensate, Ottawa lets them deduct about 25 per cent of their gross revenue under the federal resource allowance. In provinces where provincial resource payments fall below the federal allowance, companies can end up with a federal tax subsidy. If the payments are higher, on the other hand, they can be taxed twice on the portion that exceeds the federal resource allowance. The Council would allow a partial deduction for resource payments that exceed 25 per cent of gross revenue and full deduction for lesser royalties. With that in place, the federal resource allowance should be withdrawn.

Property taxes

Property taxes on businesses have more impact on overall tax rates on new investments in Canada than do either corporate or sales taxes, the Council finds. Moreover, in general, businesses pay much higher property taxes than do the owners of equivalent residential properties. Given the complexities of provincial and municipal financial arrangements, however, and the fact that the property tax is the single most important revenue source for municipalities, the Council recommends further study of the property tax system by the governments involved. It also advises that provincial governments continue to impose property assessment standards.



The need for change

Tax reform would make Canada more competitive and perhaps a better investment bet, the Council concludes.

That's because the current tax system favours selected industries "at the expense of productivity in the economy as a whole," it says. The Council's tax reform package, on the other hand, would strengthen productivity growth by letting market forces steer capital income to its most efficient use, which would "enhance Canada's overall competitiveness from an international standpoint."

Moreover, businesses in general would likely pay lower taxes under the Council's plan, because of the proposals to finance tax cuts by widening the corporate-tax base and to remove sales taxes on capital inputs. By contrast, in the United States the revenue from corporate income taxes is expected to rise 22 per cent over the next five years to finance a personal tax cut of 5 per cent. The result will "obviously make investment in Canada more attractive" than it was before, the Council says.

While the Council's tax reform package has much in common with the U.S. approach, it also differs markedly. For example, the United States has not moved to reduce double taxation of corporate shareholders by integrating personal and corporate taxes. Nor has it indexed the tax system for inflation. And while Canada has moved toward a lifetime-income tax through greater use of registered savings, the United States has curtailed such schemes. These differences are not expected to affect adversely Canada's attractiveness for investment or highly skilled labour, the Council maintains. "Indeed, the reverse may well be true," it says.

Since tax reform raises questions about winners and losers, the Council recommends gradual changes in some areas. But it opposes piecemeal reform, because the tax system is so interconnected. Nor should tax reform be interpreted as a substitute for fiscal reform. For example, tax changes that encourage personal saving do not remove the need for pension reform. There must also be a proper balance of concerns for economic efficiency and growth, on the one hand, and for fairness and even-handedness, on the other.

Personal taxes

The increased revenue from taxing capital gains in full should be used to reduce marginal tax rates and to remove elements of the tax system that discriminate against saving. The Council is aiming here for greater simplicity (by eliminating the need to devote pages and pages of the tax code to preventing the conversion of other income into capital gains) and for greater efficiency (through less tax avoidance, more efficient use of savings, and more incentive to save).

These proposals would provide Canadians with much more scope to save "for a rainy day" and for old age by averaging their incomes over time. This is particularly appropriate, the Council says, because of the increasing pressure on Canadians to change jobs frequently, to re-educate themselves periodically, and to prepare for longer and healthier retirements.

Finally, the tax burdens of different classes would not change under the Council's plan. Those with incomes below a stipulated threshold would have a tax credit to offset the impact of a business transfer tax, and all would share in enhanced access to registered savings and the growth of income that would occur under a more neutral tax structure.

Corporate taxes

The impact of changes in the corporate-tax structure would depend on the industry, the asset mix, and the debt/equity ratio of each company. Hence the proposed changes must be made with appropriate consultation, the Council says. But it insists that the biggest change – a deceleration in capital cost allowances – would be offset to a considerable extent by lower tax rates. An indexed corporate-tax system would act as an insurance policy against the distortions created by inflation and by the tinkering with the tax system that occurred in response to the inflation of the 1970s. Integrating the corporate tax with the personal tax would increase equity by reducing the double taxation of shareholders. It would also increase efficiency by reducing the present biases against equity-financing by businesses.

The Council opposes piecemeal tax reform, because the tax system is so interconnected.

Other reforms

Reform of the federal sales tax is long overdue, the Council says. While it supports replacing the manufacturers' sales tax with a business transfer tax, in general it does not think that sales taxes as a proportion of total government tax revenue should increase. In the area of resource taxation, any negative effect of the Council's proposals would be offset for most companies by a reduction in corporate-tax rates. The Council would also like to see a return to full deductibility of provincial royalties and mining taxes from income taxable by the federal government. Finally, provincial and municipal governments should study the distortions created by the property tax.

Hooking into new technology

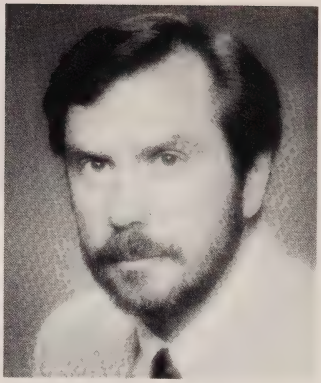
The Council will provide better policy advice in the future, thanks to some new computer software and equipment.

These acquisitions will make the Council's economic simulations more realistic by reducing the time it takes to do them, says Ross Preston, the project leader responsible for the Council's CANDIDE econometric model. That model was developed in the early 1970s and has been an essential tool in the Council's work. It is used to determine the economic impact of the Council's policy prescriptions and the effects of various economic developments, such as changes in monetary, fiscal, or trade policy, or an increase in interest rates. With the purchase of the new computer equipment and software, CANDIDE Model 3.0 is being phased out, and another econometric model is being adopted. To find out more about these changes, *Au Courant* interviewed Preston.

Au Courant: *Why is the Council making these changes?*

Preston: An econometric modeling system is like a car; every once in a while it needs repairs. Last year, Statistics Canada completely revised the National Accounts data. It changed the base year, revised all the numbers back to 1961, and in some areas even changed conceptual methods of measurement. That made CANDIDE Model 3.0 obsolete. At the same time, personal computers (PCs) were increasing in competitiveness, while the cost of buying mainframe computer time to run simulations on CANDIDE Model 3.0 wasn't falling all that quickly. We decided the best route would be to purchase some PC equipment and, instead of rebuilding CANDIDE, to enter into an outside agreement that would give us access to the econometric model used by the Conference Board of Canada, which is in fact very similar to CANDIDE Model 3.0.

Au Courant: *How is this an improvement on the previous system?*



Ross Preston

Preston: The kinds of things we can do on a PC in terms of simulations aren't much different from what we could do on a mainframe. But how we do it and the costs involved are totally different. Even after the initial capital costs of buying the equipment, we expect to save well over $140,000 in the first three years, largely because of the reduction in computer-rental time.

As for how things are done, part of the problem in the past was that by the time we got the simulation results, they were based on information that was six months old. With the new PCs, we can do in a matter of days what would have taken us a much longer period of time. Let me give you an example. We're developing an automated chartbook that can produce a whole series of graphs at the stroke of a key. These chart displays can give you a quick review of our latest economic projections using current data. We can simulate the impact of any number of changes in the economy, without requiring a lot of time-consuming activity.

Au Courant: *Does this mean our projections will be more accurate?*

Preston: In a sense, yes. Being closer to the initial conditions in terms of having current data always provides some increase in accuracy. But the economics that drives it all is important too. Accuracy depends on whether we as economists understand what's going on out there, whether the analysis we present is in fact well thought out, solid, and empirically based. Dennis Conner didn't win the America's Cup because of his boat or his crew, but because he knew how to bring it all together.

Au Courant: *What other advantages does the new system offer?*

Preston: It's very user-friendly. Anyone can learn the rudiments of the system. It brings us one step closer to the whole idea of a supermarket of results that are accessible to virtually anyone. It's much the same as going to the library and finding information through a card catalogue.

The big pay-off is that we will be able to handle more work and to produce higher quality results.

Au Courant: *How will these changes affect the Council's research?*

Preston: I think PCs in general will change the way in which we do research, primarily because of the user-friendly characteristics of the software. An economist will be able to interface directly with the system rather than have a specialist do it. Of course, you will still need the experts to develop and maintain the system. The big payoff is that we will be able to handle more work and to produce higher-quality results that are more readily understood. We can devote more time to thinking about the real problems that we're here to think about. Ultimately, this will improve the analysis on which we base our policy advice.

The growth of white collar jobs

Whether a Canadian industry has been hiring or dismissing workers over the past decade depends more on domestic demand for its products or services than on any other concern.

Or so says a recent Council discussion paper by Laval Lavallée of the Economic Council and Garnett Picot of Statistics Canada, who looked at structural change in the employment of industries and occupations between 1971 and 1981. Their analysis was undertaken, says Council chairman Judith Maxwell, "to provide us with some understanding of those factors most closely associated with employment growth and restructuring among industries and occupations . . . [to] allow us to identify those industrial sectors and occupations for which further analysis could be done."

Industrial employment

Chart A indicates the importance of domestic demand in employment needs over the period in question. According to the authors, it accounts for about 50 per cent of employment growth, in contrast with such factors as labour productivity and changes in trade, which reduced employment requirements by 8 per cent and 4 per cent, respectively.

The authors also make the following observations:

- The growth in domestic demand for manufactured goods (imported or domestically produced) was above average over the period. But because over half of that rise was met by imports, employment growth in this sector was below the average for the economy as a whole;
- Within the manufacturing sector, it was primarily domestic demand for goods and services that distinguished the fast-growing firms from the declining ones;
- All of the industries (and occupations, for that matter) that hired more workers because of changes in the trade picture were involved with Canada's natural resource base – either as resource industries, processing industries, or transportation industries. This demonstrates the effect of Canada's comparative advantage in this sector, the authors note.
- Service-sector employment grew at the expense of the goods-producing sector over the decade – primarily because of the increasing importance of service industries in the Canadian economy, coupled with the more rapid productivity growth in the goods-producing sector, which reduced its need for workers.

Occupational employment

As Chart B shows, employment grew by over 7 per cent in the professional occupations, at the expense of the blue-collar ones. The largest single explanation for this change, say the authors, was the more rapid growth in demand for the goods and services produced by the former group.

The authors also found that in some cases – particularly processing, machining and product manufacturing – growing demand was met by an increase in imports rather than in domestic production.

Another major reason that jobs grew faster in some occupations lies in the changing skill requirements of industries during the period. These may have been the result of changes in production processes, or technology, or the types of information that companies needed for their operations. Technological change probably played an important role in this restructuring, the authors add, but their analytical approach did not allow them to measure its precise impact.

"Structural change in employment of industries and occupations, 1971-81: An input-output analysis," by Garnett Picot and Laval Lavallée. Discussion Paper No. 316.

Chart A
How demand affected industrial employment in Canada, 1971-81

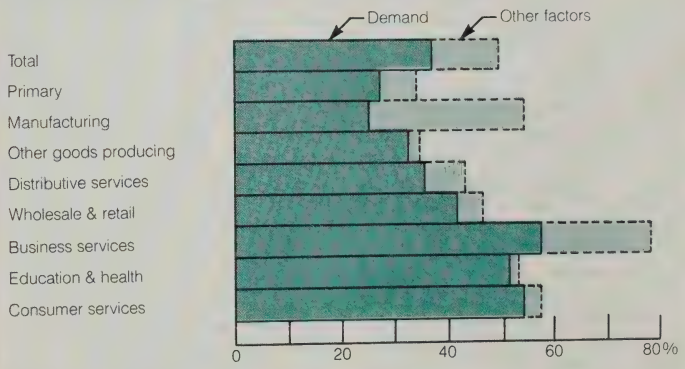
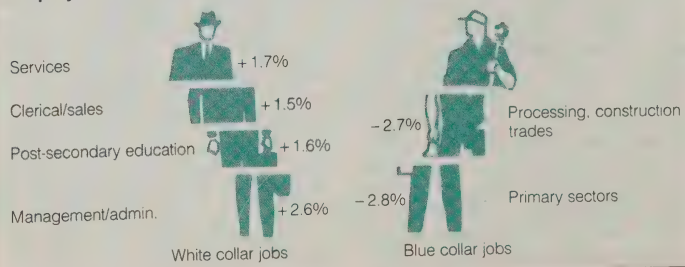


Chart B
Employment shifts in major occupations in Canada, 1971-81



Issues in financial reform

London had its Big Bang. Tokyo is opening up to world transactions. New York is leading in the securitization process. Financial systems are changing all over the world, and Canada is no exception. Quebec led off with its 1984 Insurance Act; the province of Ontario is moving towards sweeping reforms to its securities industry; and last December the federal government proposed significant changes to the organization of the Canadian financial system.

The Economic Council of Canada took an active part in the consultation process leading to this re-regulation of the Canadian financial system. Last November it released a Statement including 31 recommendations that provided a framework for the reform of financial regulation (see *Au Courant*, Volume 7, No. 3). The recommendations were based on the research findings that have been spelled out in a new report entitled *A Framework for Financial Regulation*.

Needed balance

The Canadian financial system – the banks, the credit unions and caisses populaires, the trust companies, the insurance companies, the securities firms, and others – plays a crucial role in the economy. It acts as the middleman between savers and borrowers. It provides for the safekeeping of funds. It offers information on financial services, corporations, interest and exchange rates, and the economy in general. It contributes to the maintenance of a payment system. In short, it is the backbone of modern monetary economies. If it is to perform its role efficiently, markets must be competitive; institutions must benefit from the confidence of the public; and all Canadians must have access to financial services from coast to coast. But competition, confidence, and access cannot be achieved simultaneously. Active competition, in fact, may cause insolvencies, which may in turn lead to a loss of confidence. One of the objectives of regulation – in the form of corporate governance, self-regulation, or direct government involvement – is to guide the financial system to the best achievable balance between competition, confidence, and access.

Concentrated markets

One measure of competition is the degree of concentration in the financial system. While market concentration – the share of an industry's output accounted for by a small number of firms – should be the primary concern in this respect, recent debate has often confused it with concentration of ownership (the distribution of the shares of an institution) and concentration of power (the ability to influence regulators, legislators, or other institutions because of the size of assets of an institution).

Concentration of ownership has increased over the past few years. A series of mergers and acquisitions and the recent growth of financial holding companies have led to an increase in the number of financial institutions under the control of a few shareholders. Concentration of assets is also high. Among banks, trust and loan companies, and life insurance companies, the four largest institutions accounted for 52 per cent of total assets in 1984. By comparison, in 1983 the four largest manufacturing enterprises accounted for only 11.1 per cent of total assets.

Market concentration, while generally high, has tended to decrease in recent years. In the deposit market, dominated by the large Schedule A banks, the four largest companies accounted for about 48 per cent of deposits in 1984, down from 54 per cent in 1979. In the personal and commercial loan market, also dominated by the banks, the four largest companies accounted for 63 per cent of loans in 1984, compared with 70 per cent in 1979.

In the mortgage market, which has the lowest level of concentration of all markets considered, the four largest companies accounted for almost 33 per cent of total mortgages outstanding in 1984, up slightly from 30 per cent in 1979.

While concentration appears quite high in most financial markets, this doesn't mean there is no competition whatsoever. On the contrary, research shows that it increased over the last few years. But the continued existence of an "uneven playing field" hinders the competitive efforts of various institutions. Firms in the different financial pillars are subject to different legislation and regulation even though they serve the same customers.

Research shows that competition in the financial sector has increased over the last few years.

Unequal access

An important measure of how well the financial system serves the needs of all Canadians is the availability of financial services. In that regard, over 1,700 localities in Canada are served by only one pillar (excluding the insurance business). That means the bank branch or the local financial cooperative is the only available point of sale for a great number of Canadians who live outside the larger urban centres; trust companies or investment dealers are not directly accessible in many areas of the country.

Responsibilities and harmonization

The absence of a clear sharing of responsibilities and a lack of harmonization between the federal and provincial authorities explain in large part why the existing regulatory framework is unable to provide for a level playing field and to cope efficiently with the recent financial difficulties faced by many institutions. The Constitution gives the Parliament of Canada authority over banking, the means of

payment, trade, commerce, bankruptcies, and matters of national interest, while provincial legislatures have authority over property rights, contracts, and regional concerns. As financial transactions are carried out via a contract procedure, they tend to fall under provincial jurisdiction. At the same time, the federal responsibility for banking can – and does – encroach upon this provincial authority. Moreover, the courts have, time and time again, reaffirmed the federal authority – for example, in the 1938 and 1947 Privy Council decisions, and in the 1980 Canadian Pioneer Management case.

Yet the definition of "banking" remains an issue that has not been resolved. The courts, however, have linked it to the provision of the means of payment, and a similar definition has been proposed by the Economic Council.

All these issues – and many more, such as solvency and conflict of interest, for example – are crucial to the efficient functioning of Canada's financial sector and to its ability to maintain its world-class status. Regulators will have to bear these concerns in mind as changes in the financial sector make further regulatory reform necessary.

A Framework for Financial Regulation (EC22-137/1987E; $8.95 in Canada, $10.75 elsewhere).

The softer side of technology

The following passage is an excerpt from the Economic Council's best-selling publication *Workable Futures: Notes on Emerging Technologies:* (For ordering information, see publications page.)

In addition to some of the "hard" technologies like robotics, there are other innovations – in organizational design, for example – that may ultimately be as important as productivity and competitiveness.

Statistical process control

Using SPC, the Court Valve Company of St. Catharines, Ontario, became the first Canadian firm to receive General Motors' number-one supplier rating. In the 1983 model year, Court shipped three-and-a-half million pieces, in the form of 33 different components, to GM; there were no rejects.

In its simplest form, SPC is the use of basic statistical concepts to monitor how consistently a product fits engineering specifications. At various stages of a production run, tests are made to determine the conformity of the product with various critical characteristics, such as weight and dimensions. Results are recorded and charted to show how the samples checked compare with specified tolerances. Minute variations recorded in the process can warn skilled SPC users of potential problems. Changes in the patterns of variation over time can be traced to a host of factors, such as material quality, environmental conditions (heat, pressure, etc.), servicing intervals, or operator skill. In this way, SPC cannot only show how well a particular product conforms to specifications, but can also be used as a diagnostic tool to predict and correct defects in the production process.

In Japanese hands, SPC has been used to promote an approach-to-work organization in which production and inspection are no longer separate and antagonistic but merged and self-supporting: production workers are their own inspectors. In Canada's automotive industry, more than 60 per cent of parts manufacturers have given some SPC training to hourly workers in the last two years.

Certainly the pressure of demand from automobile assemblers – who have explicitly made the use of SPC by suppliers a condition for doing business with them – has led to a spectacular rise in this quality-control technique since 1980. The percentage of companies using the technology shot up from about 7 per cent in 1980 to over 80 per cent today.



Just in time or not at all

" . . . in 1980 an auto assembler might have had several weeks' production of seats on hand. Now, assemblers may take hourly delivery of seats of the precise colour and materials required for that day's production. Planning is such that seats can be unloaded from the delivery truck in the exact order that they are required on the assembly line." (Report of the Automotive Industries Human Resources Task Force, January, 1986.)

The essence of the just-in-time (JIT) approach is to eliminate costly inventory. But the reduction of inventory itself imposes the need to identify and quickly solve production problems. It also imposes the very highest standards for quality control: if inventory is to be minimized (and the target is zero), there is no room for rejects. It is clear, therefore, that JIT and SPC go hand in hand.

The increased flexibility of delivery means ability to switch quickly to smaller production runs and, in turn, places a premium on quick changeover, increased machine utilization, and enhanced preventive maintenance.

Like SPC, JIT is being adopted rapidly, particularly in the automotive sector. An interesting aspect of this process is that just as the assemblers have required their suppliers to adopt SPC and JIT, those parts manufacturers will, in turn, tend to demand adoption by their own suppliers. Ultimately, the system will be founded on computer communications between assemblers and suppliers, using common, industrywide specifications and terminology.

S·P·E·A·K·I·N·G · O·U·T

Prairie agriculture, a key element of the western economy, has struggled through drought, grasshoppers, and falling wheat prices in recent years. What lies ahead? How should policymakers and farmers prepare for future world markets?

The Economic Council of Canada is setting out to answer these questions in a research project on the future of Prairie agriculture, headed by Dr. Andy Schmitz, a leading agricultural economist in both Canada and the United States. He is now at the University of Saskatchewan in Saskatoon.

Schmitz, who will be based in Saskatoon, will lead a group of about 10 researchers in wide-ranging studies to be completed by mid-1988. He took time recently to discuss the state of Prairie agriculture and the Council's project plans in an interview with *Au Courant*.

Au Courant: *How important is Prairie agriculture to the western economy?*

Schmitz: Well, it's extremely important. And this holds true even outside Saskatchewan, where agriculture is more important for the total economy than in Alberta or Manitoba. Just as an indication, last year the Prairie region, overall, produced somewhere in the neighbourhood of a billion bushels of wheat. So if the price of wheat drops by $1.50 or $2.00 a bushel, you're talking about a $2-billion shortfall. And if you then go ahead and look at some multiplier effects, that $2 billion could easily exceed, let's say, $5 billion.

Au Courant: *By "multiplier effects" you mean an impact on farm machinery industries, that kind of thing?*

Schmitz: Right. This is what I think we have to keep in mind in the Prairie region. We're not just talking about farmers; we're talking about the service sector that's related to agriculture. This includes fertilizer producers and dealers, farm machinery dealers, and the whole gamut of industry that's tied into agriculture.



Andy Schmitz

Au Courant: *What are the current problems facing Prairie agriculture?*

Schmitz: Well, they started about three or four years ago, at least in Saskatchewan, with the extreme drought and the grasshopper infestation. These conditions meant that a lot of farmers were hit by crop failure. Then prices dropped substantially, partly as a result of the international price subsidy war that was taking place. This year, in parts of Saskatchewan and also in Alberta and Manitoba, the yields were substantially higher than normal, and acreage was at an all-time record in terms of wheat, but quite a few of the farmers never got their crop harvested because of extremely bad weather conditions at harvest time. So some farmers have ended up with low-grade wheat, which doesn't move fast on international markets and which brings in lower prices. As a result, they're having a tremendous cash-flow problem. Also, while it's true that input prices are starting to come down – interest rates have dropped; fertilizer, until recently, was actually declining in price; the farmers got a rebate on fuel from both the federal government and the Saskatchewan government – the drop in the cost of inputs certainly hasn't offset the drop in the price of the final commodities, which, in this region, include wheat and other crops.

Au Courant: *What kind of effects are all these problems having on the family farm at this point?*

Schmitz: Well you know, we really don't have a very good feel for what's going on in the rural areas with respect to the stress on farm families. I gather data the best I can from medical doctors and people in the industry, which suggest that the crisis really hasn't hit yet – that people are just starting to go through this whole stress crisis, and they're going to have some serious problems in the future. There are signs now of increased suicide rates among farmers, increased alcoholism among farm families, and a higher divorce rate. Another problem is the impact on rural communities. If things stay this dismal for several years, then many of our rural communities will probably go by the wayside, and there'll be fewer and fewer rural people in the Prairie region. These questions have to be looked at, along with the cost of wheat or the cost of inputs.

Au Courant: *How about the global markets for Prairie agriculture at this time, and how do you see them developing?*

Schmitz: Well there's no doubt that certain sectors in Prairie agriculture are doing very well. Right now, for example, some of the people producing eggs, chickens, and broilers, as well as some of the dairy farmers, may not be doing magnificently, but at least they're not suffering as much as, say, the wheat farmers. Also, the beef sector, at the moment, is in excellent shape. For the first time in years, the livestock industry in the Prairie region has really been buoyant and is likely to stay that way for several years to come. But the grain sector is another story. I happen to be somewhat optimistic about the future, but that view is not shared by many of my colleagues or people in the farming business. I

think that within four or five years the grain industry could be healthy again. But certainly in the near term, given the world buildup of stocks, one has to be pessimistic about grain prices. I just looked at some numbers again on the stocks of U.S. corn, and when you talk about a 5-billion-bushel surplus of corn, you know, that has to have a depressing effect on the whole feed-grain market. That doesn't mean that we won't have a good export market for malt barley, but certainly it raises questions about what prices are going to be like for feed barley over the next two to three years. When you look at the world stocks of wheat, and especially those held by the United States, things look doubtful. But what makes this outlook even more pessimistic is the use of subsidies by the European Common Market, which I think are totally distorting world trade and Canada's comparative advantage in international markets.

Au Courant: *Can we turn now to the Council project? What is its overall objective?*

Schmitz: The broad objective is to examine those factors which have shaped the current structure of Prairie agriculture and those which will influence its future, and to determine how the future direction of Prairie agriculture can be integrated with various policy choices.

Au Courant: *What sort of policy choices are you talking about?*

Schmitz: Well, for example, we'll look at the issue of whether Canada should continue to specialize in low-yielding, high-protein wheat. One of the questions raised in recent years is whether a country should produce high-yielding varieties of low-protein content, as opposed to low-yielding, high-protein varieties. Another policy area we'll be looking at is Canada's role in promoting international export cooperation or other such policies. In other words, how can we try to convince other nations to stop their subsidy wars? Another example has to do with policies integrating livestock and grain. For instance, what would be the implications of introducing a stabilization program that would benefit not only grain producers on the Prairies but also livestock producers over the long haul? Look at our exports of beef to Japan. At present, Canada has only a small share of the Japanese beef import market, unlike countries like the United States and Australia. We'd like to find out whether the barriers to Canada's beef exports are largely political or economic. And we'd like to determine how we could do better in penetrating the Japanese market.

If things stay this dismal for several years, then many of our rural communities will probably go by the wayside.

Au Courant: *Can you give me some details about the specific areas you plan to study?*

Schmitz: Number one, to be explicit, is to examine agricultural policies in major importing and exporting countries and determine the extent to which they have contributed to the world grain glut. Number two, we want to determine whether the excess supplies on world grain markets today are short-term aberrations from a long trend or whether the trend has just shifted upward. Number three, we want to determine whether Canada's traditional markets for grain are fading and whether there's a need to diversify into markets of newly developing countries. Number four, we want to explore the potential for greater diversification in livestock production. Number five, we want to examine the programs that are currently in place or that are in the process of being implemented, including farm finance and the family farm. Number six, we want to look at the human cost associated with the financial difficulties resulting from depressed farm incomes. We should also take a look at some of the multiplier effects I talked about earlier. Number seven, we want to discover how much of the change in farm incomes over the past decade or two has come from changes in farm prices and how much has come from yield technology. Number eight, we want to determine how serious the existing institutional barriers are to further diversification and how they could best be removed. Finally, we want to see whether Canada's long-run competitive advantage is in wheat and feed-grain production or in other areas of agriculture.

Au Courant: *How do you plan to go about your research?*

Schmitz: We're going to use several approaches and then, hopefully, integrate them. First of all, we will review what has already been done in these areas. Second, we'll supplement this with our analysis of existing data and also with interviews with different people. Then we'll use some fairly elaborate econometric models that are already in place. For example, we plan to hook into what is called the FAPRI Model – a food agricultural policy model used by the United States – as well as other large, mathematical models in use there.

Au Courant: *One final question, which perhaps wraps everything up. How important is the future of Prairie agriculture to the average Canadian?*

Schmitz: Well, again, I think it's very important. First of all, Canadians have to eat. And therefore they have to buy beef, and pork, and poultry, and eggs, and bread, and all those commodities. So it's important that Canadian agriculture remain efficient and competitive from the food-price standpoint. Second, the multiplier effects from Prairie agriculture work their way through the entire economic system. For example, eastern manufacturers sell tractors, trucks, farm machinery, cars, and consumer goods to the Prairies. So you could say that Prairie agriculture is a Canadian issue. And, third, Prairie farmers produce grain for world markets; those exports improve Canada's trade balance; and that benefits all Canadians.

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Economic Council of Canada

Volume 8, No. 1, 1987

Making technology work



- The rising cost of hospital care
- A new project on regional development

PUBLICATIONS

New Council Statement

Making Technology Work: Innovation and Jobs in Canada (EC22-142/1987E; $4.95 in Canada, $5.95 elsewhere).

In this Statement, the Council examines the impact of technological change on the labour market, including its impact on jobs, income, and on particular groups of workers such as women, young people, older workers, and the disabled. It identifies the technologies that have been introduced and the kinds of firms that innovate. It also looks at the management of innovation within firms and its impact on Canada's industrial relations system. In addition, the Council puts forward a policy framework designed to encourage rapid technological advance while minimizing the costs of adjustment.

New Council Report

Innovation and Jobs in Canada (EC22-141/1987E; $10.95 in Canada, $13.15 elsewhere).

This research report provides the detailed analytical findings that support the Council's Statement on the impact of technological change on the labour market.

Colloquium Proceedings

The Council's two-day Colloquium on Aging with Limited Health Resources pinpointed some of the key issues and potential developments in the health care field that will confront Canada as a result of its aging population. It brought together some 100 participants from diverse backgrounds in scientific and social research, economics, health administration, and government. A summary of the Colloquium proceedings was featured in *Au Courant* (Vol. 7, No. 1). The papers presented at the Colloquium have also been collected in a volume of proceedings, which can be ordered in accordance with the information below.

Aging with Limited Health Resources: Proceedings of a Colloquium Held in Winnipeg, May 1986 ($9.95 in Canada, $11.95 elsewhere).

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request. Each study clearly attributes the findings and conclusions to the individual author or authors rather than to the Council. (Ordering information below). One new title has been published since the last issue of *Au Courant.*

Canadian Hospital Costs and Productivity, by *L. Auer* (EC22-138/1987E; $8.95 in Canada, $10.75 elsewhere).

Reprint

The following Council Statement has been reprinted and can be ordered in accordance with the information below.

Competition and Solvency: A Framework for Financial Regulation (EC22-134/1986E; $4.95 in Canada, $5.95 elsewhere).

How to order

Research studies and Council reports are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion Papers, *Au Courant* and the *Annual Report* are available without charge from the Information Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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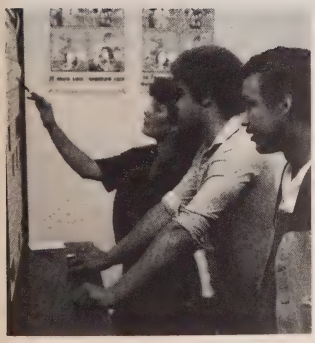
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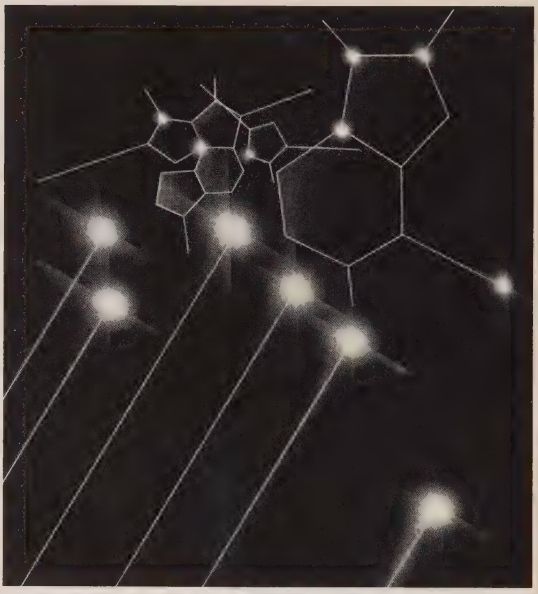
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Editor: *Barbara S. Campbell*

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Making Technology Work

Innovation and Jobs in Canada



Canadian jobs and living standards are at risk because of this country's failure to perform better in the global technological race, says the Economic Council of Canada.

The fact that Canada lags behind many other industrialized nations in the development and use of new technologies is "an urgent national problem of major proportions," the Council says in its Statement, *Making Technology Work: Innovation and Jobs in Canada*. At the same time, Canada needs policies to encourage technological change while minimizing the costs of adjustment. "The two points are mutually dependent," the Council explains. "Without rapid technological advance we stand to lose competitiveness and jobs. Without a secure, flexible, highly skilled work force we face slower technological advance."

Much of the evidence put forward in the Council's Statement (a separate research report contains detailed findings) is based on results of the Working with Technology Survey – the first of its kind in Canada and one of the most comprehensive worldwide. The survey looks at how widely computer-based technologies have diffused in Canadian industry and how firms are responding to them. Close to 1,000 establishments responded in all industries except agriculture, fishing, construction, and public administration. The survey focused on the computer-based technologies because they are expected to have the most wide-ranging impacts on work in the short-to-medium term; they have evolved rapidly, diffused widely, and are highly visible; and they are considered an "enabling" technology that permits change in other fields.

The results

Seventy-five per cent of the survey respondents introduced some type of computer-based technology between 1980 and 1985. Almost two-thirds was in the form of office automation equipment (personal computers and word processors, for example); slightly less than a quarter, in process technologies (such as computer-aided manufacturing and design, computer numerical control, and automated material handling); and the remainder, primarily in industry-specific applications. The expected trend in the 1986-90 period is towards increasing diffusion and more sophisticated use of all types of computer-based technology, and more emphasis on process automation in particular. Most firms cite increased productivity as the main reason.

To determine which industries used computer-based technology the most, the Council developed two measures of "technological intensity": the ratio of employees who were actually working with computer-based technology; and the ratio of expenditures on that technology to total sales over the period. Four industries ranked high on both counts: communications and other utilities; wholesale trade; finance, insurance, and real estate; and business services. Three sectors scored particularly low: leather, textiles, and clothing; wood and furniture; and primary metals.

International comparison

While Canada does have some notable technological strengths – in telecommunications, large-scale engineering, agriculture, and forestry, for example – the majority of Canadian producers are slow to adopt innovative practices. In particular, there is a substantial Canadian lag behind other countries in the adoption of process automation technologies, while capital investment in this area "is also lagging seriously," the Council reports. The gap between Canada and other countries is even wider because of Canada's lack of experience in learning how to apply the new technologies.

"The stakes are high and getting higher, and Canada has to act now," the Council says. "Failure to do so will lead to a loss of prosperity and jobs as Canada's competitive position deteriorates."

While many Canadians have welcomed technological change, others share misgivings about its impact on jobs and income. The Council examines this issue at length, including the impact of new technology on women, young people, older workers, and the disabled. It also looks at the management of innovation within firms and its impact on Canada's industrial relations system. Finally, by determining where the impacts of technological change are likely to be felt, the Council is able to suggest policy responses that will encourage technological advance while minimizing the costs of adjustment.

Tech change and the job market

The new technologies have the potential to create both winners and losers.

Thus, while some occupations will experience significant growth in numbers, others – notably clerical and machining and related occupations – will dwindle. The mismatch between patterns of growth in some occupations and decline in others will create serious problems in terms of labour market adjustment. Even within occupations, many of the new jobs created by tech change will be available only to those who are capable of working with the new technologies. To compete, Canada needs "an industry structure and a labour force that are adaptable in the face of change and that are responsive to it," the Council says.

Historical trends

To project the impact of tech change on future employment, the Council initially looked at historical trends. It also had to disentangle the effects of tech change from other factors shaping the economy, such as changes in demand and in the mix of goods and services used to produce a product. (In automobile production, for example, more plastic and fewer steel parts are being used today.)

In isolation, new technologies and innovative management practices can increase productivity and thus reduce the need for labour. But productivity growth also increases efficiency and subsequently raises producers' and workers' incomes, which stimulates demand. Hence more workers are needed to meet the higher demand. So, indirectly, tech change can increase employment. Between 1971 and 1981, in fact, total employment grew by 30 per cent in Canada primarily as a result of growth in final demand.

Of the 85 occupational groups the Council studied, tech change had a positive net effect in the vast majority of instances. (Only in the cases of general office clerks, farmers, nursery and other farming occupations, textile processing, "other" metal machining, labouring in construction, and "miscellaneous" occupational groups did employment decrease over the period.) Moreover, tech change acted to increase employment directly in 43 per cent of the occupations employing 36 per cent of all workers. As well, some wholly new occupations were created (including videotex page designers, fibre-optic cable splicers, and nuclear technologists), while others disappeared (pneumatic riveters and rail switch repairmen, for example).

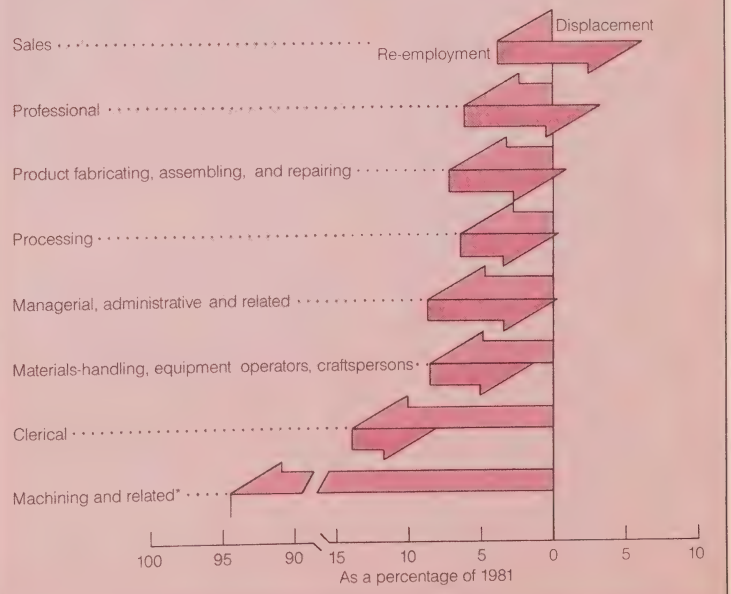
High-tech sector

To see how users of new technologies compared with non-users, the Council classified industries as low-, mid-, or high-tech, based on the proportion of their intermediate inputs that was considered high-tech. An industry that purchased sophisticated electronic components to produce a finished product would be considered high-tech, for instance. Among the high-tech industries are communications; finance, insurance, and real estate; machinery; electrical and electronic products; and trade.

Overall, the high-tech sector

How tech change will affect employment by 1995

Relative to 1981 employment levels by occupational group



*Projections indicate virtually no re-employment (0.4%)

experienced higher rates of employment and output growth throughout the 1970s and into the 1980s than did the mid- and low-tech sectors. Only in a few industries – notably electrical products and automotive industries – did output growth in the 1981-85 period fail to offset the negative employment impacts associated with productivity growth, with the result that recent employment growth in those industries was negligible. The high-tech industries also fared better in terms of cost efficiency and had higher wages and wage-rate growth over the period. Even though jobs grew more rapidly in high-tech firms, however, labour displacement still occurred. Some staff were transferred, some underwent retraining, and others were laid off. In all, tech change caused "major shifts" in the occupational structure of employment, the Council concludes.

Employment projections

Three elements will critically affect the nature and scope of labour market adjustment in the future: how well the economy performs (demand); how evenly the productivity gains are shared; and how well the impact of the various technologies on employment is understood. In the last regard, the Council breaks new ground by incorporating into an employment-projection model technical information on how labour market requirements change when microelectronics-based technologies are introduced into the office and on the shop floor.

Using its Microelectronic Simulation Model in a number of scenarios, the Council finds the impact of tech change to be highly uneven across occupations. While it has the potential to cause considerable worker displacement, tech change can also produce large productivity payoffs, resulting in new jobs or "re-employment" (see chart). In fact, such re-employment more than offsets the displacement effect in sales; professional occupations; product fabrication, assembly, and repair; processing; and managerial, administrative, and related occupations. Certain other occupations may, however, experience considerable job losses, most notably machining and related occupations, and clerical jobs. Materials handling, equipment-operating, and crafts occupations are affected negatively as well.

Middle-class erosion

Major debate rages over whether tech change is eroding the size of the middle class by creating high-skilled and low-skilled jobs, but few in between. New technologies are also said to contribute to the shift in jobs from goods production to service industries, many of which offer low-paying and part-time work only. While the Council did not find any conclusive evidence, it points to a number of possible warning signs of middle-class decline.

There are disquieting signs that changes in the composition of the middle class are taking place.

First, in many respects, Canada is still only at the early stages of the current wave of technological advance. As the new technologies evolve and spread, shifts in the distribution of income may yet occur. Indeed, in the United States, where tech change has progressed more rapidly, indications of a middle-class erosion do exist. Second, there are disquieting signs that changes in the composition of the middle class are taking place. The Council emphasizes that such changes "must be reflected in the policies that are put into place to facilitate adjustment."

Tech change and women

For women generally, tech change holds out prospects of benefit and bane. On the one hand, women held more than half the new jobs that were created in the high-tech sector over the 1971-81 period. On the other, female employment was heavily concentrated in three industries that employ high proportions of clerical workers – retail trade; finance, insurance, and real estate; and services to business. Hence it appears that the disturbing trend towards "ghettoization" of women in clerical occupations is continuing in the high-tech sector. Moreover, as employment opportunities dwindle in manufacturing and in transport, communications, and other utilities (where relatively good pay and working conditions are found), the balance of job availability has shifted to industries such as community, business, and personal services; and finance, insurance, and real estate – where many female workers have experienced relatively lower earnings, and less stable and permanent labour-force attachments.

Furthermore, part-time work has been on the increase in recent years, and almost three-quarters of it is accounted for by women. While the majority of women who are working a shorter week appear to want only part-time jobs, a growing minority would prefer full-time work. Finally, women in high-tech industries do not necessarily earn the highest incomes. Average employment incomes for a range of clerical occupations in 1980 were consistently lower in this sector, in fact.

Special groups

Tech change may also exacerbate the disproportionate employment difficulties of young people, older workers, Native peoples, and the disabled, the Council says. For example, Native peoples' concentration in a few primary activities (hunting, fishing, trapping, and forestry) and in remote areas of the country may isolate them from the opportunities that new technologies present. For the disabled, physical access remains a problem. For young people, the often bewildering array of career choices is now complicated by a rapidly unfolding occupational structure and accelerating obsolescence of skills. The latter development has an even greater effect on older workers.

Each of these groups suffers from major inadequacies in education, the Council finds. Moreover, tech change conspires most notably against the least educated groups by creating fewer employment opportunities for them. "A recurrent theme in all aspects of our work on employment and new technologies is the crucial importance of education and training," the Council points out. If young people are ill-prepared educationally, they could well be the victims of the new technologies. For the substantial portion of the working-age population who are beyond normal schooling years and who suffer educational deficiencies, imaginative remedial programs of literacy, educational leave, and private and public vocational training are needed.

Innovation in the workplace



Tech change is more than just robots and computers.

As the Japanese and Swedes have demonstrated, it also involves creating an innovative workplace environment to inspire the "people" side of the enterprise. In Canada, though, far too many organizations pay only lip service to that principle, the Council says.

Since most tech change requires new skills, for example, training is important. While there have been instances of substantial employer-sponsored retraining in Canada as a result of tech change, the Working with Technology Survey suggests that these efforts are not typical. To date, most training has been relatively informal and of short duration. More than half of it involved clerical workers only. When tech change affected high-level skills, companies generally tended to hire externally rather than upgrade existing personnel. Since most tech change involved relatively small, stand-alone office applications, companies have been able to get by thus far without much staff retraining. But the number of people working with sophisticated technologies – from robots to computer numerical control - is expected to rise dramatically in the future.

Innovative practices

The Council's research suggests that there are two essential ingredients in organizational innovations: the organization of work (job redesign through enlargement, rotation, or enrichment, for example); and processes for decision making (such as quality control circles and various forms of industrial democracy). Comprehensive models of organizational innovation contain elements of both.

Among the 65 per cent of respondents in the Council's technology survey who instituted some type of organizational innovation, the most common form was decision-making arrangements, such as joint labour/management committees. These committees, however, tended not to have a major participative role in the tech-change process. Other forms of innovation were reported less frequently. Still, increasing numbers of Canadian companies recognize the benefits of workplace innovation, including increased productivity, cost reductions, lower absenteeism, better safety records, and enhanced quality. "On balance, however, it appears that many establishments in this country are operating according to traditional principles of work design and decision-making," the Council concludes.

Industrial relations

Tech change is creating serious challenges for Canada's industrial relations system as well. For one thing, it appears to be threatening union membership by accelerating the shift in employment away from traditionally unionized occupations, since collective bargaining is practised least in the industries labelled high-tech. In some instances it may also threaten the relative bargaining power of unions by offering employers the potential to control production off the shop floor (in automated factories, for example). In principle, however, union officials tend to accept tech change, provided that consultation precedes its introduction and that management makes every effort to minimize the adverse effects on workers.

Collective bargaining

At the moment, only a minority of Canadian labour contracts have clauses related to tech change. (The Council looked at written agreements because they are the "rule book" governing the union/management relationship.) The most common clause was "advance notice prior to the introduction of tech change"; however, it was absent from over 60 per cent of the agreements examined. Even after legislation was enacted to encourage collective bargaining over tech change – in Manitoba, Saskatchewan, British Columbia, and federally – the change in the incidence of techology-related clauses was modest. Furthermore, collective bargaining over tech change has not been very successful, partly because of restrictive definitions of what constitutes tech change and partly because of the difficulties in separating its effects from other factors causing job displacement. Finally, of the four jurisdictions, three (excluding B.C.) allow parties to opt out of the legislation, provided agreements have clauses to resolve tech change issues.

Blueprint for action

Tech change will bring economic progress and jobs to Canada – provided that businesses apply the new technologies more rapidly and that governments adopt the right labour-market-adjustment policies.

At the moment, however, there is cause for concern, for the following reasons:

- Canadian industry continues to lag behind other countries in adopting new technologies.
- Tech change is never smooth and balanced. It creates both winners and losers and Canada must do a better job of helping the losers cope. And,
- The pace of change in the global economy will remain rapid and may accelerate. The next round of innovation will have more profound employment consequences.

In the Council's view, Canada lacks the explicit national commitment to new technologies and the cohesive framework of policies that must accompany such commitment. Accordingly, the Council has developed a policy framework that rests upon the "twin pillars" of recognizing the need for rapid technological advance, as well as human resource development. In constructing its framework, the Council was guided by the following principles:

- The choice of technologies, training, and adjustment mechanisms will generally be market-driven.
- At the same time, governments have an important role in establishing the climate within which change must occur.
- Governments should continue to finance training and other adjustment policies, but this should be done mainly through the reallocation of existing funds rather than through substantial new expenditures.
- Adjustment programs must be flexible enough to meet the varying needs of individuals. And finally,
- The common interest among Canadians in sharing the prosperity and jobs that tech change can bring should be recognized and enhanced.

The Council puts forward a number of specific policy measures to support each of its five major policy objectives.

Technological advance

First, in order to increase productivity, competitiveness, incomes, and employment, Canada must openly embrace the new technologies. To support this objective, the federal government should raise the status of the Minister of State for Science and Technology to that of senior Cabinet Minister. Provincial governments and the media can provide leadership too, by raising the profile of science and technology issues. In addition, the Council sees two ways to improve the extensive network of high-tech and innovation centres that have been established in recent years to promote technological advance. First, a directory is needed to help entrepreneurs identify which centres are the most appropriate for the needs at hand. Second, the expertise of all centres should be rounded out to include not just the purely technical aspects of tech change but the human-resource planning and management aspects as well. Since Canada must stay attuned to advances in technology and their impacts, the Council also suggests focusing the efforts of the Canadian Labour Market and Productivity Centre on the single, urgent, and enormously important national issue of tech change.

A skilled work force

The Council's second policy objective recognizes that while new technologies are vitally necessary, alone they are insufficient. A well-trained, flexible, and committed work force is equally important.



In the area of education, a two-pronged attack is necessary. First, school retention rates and average educational attainment levels must be raised to improve the prospects of new entrants to the labour market. Second, for the adult worker, imaginative remedial education programs and vocational training are required.

In the workplace, support for employer-based training programs in selected highly skilled occupations affected by tech change should be an explicit priority in federal training programs. The Skill Investment component of the Canadian Jobs Strategy is of considerable interest to the Council because it supports the kind of skills-development arrangements called for in a high-tech labour market. But ways must be found to make these

approaches more attractive because of the poor "take-up" rate by individual companies. The Council also focuses attention on the feasibility of a paid-education-leave policy in Canada, possibly through a voucher-style program to cover the costs of employer- sponsored training. In this way, workers could spend the vouchers (on tuition, for example) to learn the skills they consider most appropriate. At the same time, the federal government should build on the Council's innovative work in the area of labour market forecasting, so that Canadians can better anticipate the effects of tech change on the job market.



Adjustment assistance

Since tech change is uneven and disruptive, an adjustment policy is required to minimize the costs and share the benefits. To support this policy objective, the Council suggests expanding the federal government's Industrial Adjustment Service (IAS) through a gradual increase in its financial and personnel resources. The IAS encourages labour and management to work together when economic or tech change causes labour market adjustments. At the moment, it lacks the resources to meet a substantial and growing market for its service.

A national adjustment policy must also give special consideration to those people and groups who may assume disproportionate transition costs. In particular, part-time workers – many of whom are women, older workers, the young, and the disabled – are penalized by not sharing proportionately in the benefits and protection available to full-time workers, such as private-pension-plan coverage and eligibility for unemployment insurance. While this issue is complex, it must be dealt with now, in view of the sheer extent of part-time employment, the Council notes. Disabled persons may be disproportionately affected by tech change as well, despite the opportunities for advances in their quality of life. Solutions to meet their special needs in the workplace are often simple and inexpensive but not always obvious to employers who have had little experience in this regard. The Council says an agency like the Job Accommodation Network in the United States could be established in order to supply information on technical aids and architectural modifications, to provide real-world examples of similar situations and the solutions developed, and to recommend types of equipment and sources of supply.

Innovative management

Because successful tech change depends as much on innovation in the organization of firms and in the development of human resources as it does on technical expertise, Canada must innovate on both fronts. In other words, the most successful businesses will employ managers who have some technical understanding, as well as scientific and technical staff who have some sense of business management. And both will have an appreciation of the relationship between human resources and technological change. Too often, however, the bridges between these skills "are conspicuously absent," the Council says.

Accordingly, steps should be taken by engineering and business schools to produce more fully rounded graduates. There should also be stronger links between the business and advanced-education communities through cooperative education and exchange programs, including more at the senior-management level. For a system of exchanges to work, however, participants should not see their career prospects threatened by a move to another environment for a period of time. The growing trend towards having business people advise on academic programs should be taken one step further by involving them directly in learning and teaching experiences. Generally, cooperative arrangements produce large payoffs by helping businesses and educational institutions allocate their resources more efficiently and effectively, the Council notes. Industry associations can play a coordinating role in this regard.

Innovative management within companies is needed as well, with the focus on the management of people, the interaction of managers and workers, and the organization of work. The key ingredients of an effective and enlightened management style that were distilled from the Council's case studies include: preplanning of both the social and technical aspects of innovation; involvement of all the principal stakeholders in the innovation process; development of more collaborative and flexible work designs and methods; commitment to the existing work force; retraining and skills development; and management training that imparts an understanding of the organization and of the human-resource consequences of tech change.

Industrial relations

Finally, a more constructive industrial-relations climate is essential if Canadians are to enjoy the fruits of technological progress in a fiercely competitive world, the Council says. In this respect, British Columbia's current legislative approach to tech change would be helpful to other jurisdictions. Companies are unable to opt out of the B.C. legislation, as they can elsewhere; there is a less restrictive definition of what constitutes tech change; and a procedure exists for referring technology-related disputes to binding arbitration.

Other measures are needed as well, because the majority of Canadian workers are outside the collective bargaining system. In addition, many public-sector workers are barred from negotiating tech-change issues, and formal bargaining over technology tends to be sporadic and, too often, defensive in nature. The Council supports the idea of establishing labour/management committees empowered to deal with such concerns as job wages, retraining, and health and safety issues arising from tech change. The Council's intention in making this suggestion is not to circumvent existing collective arrangements but to encourage employers and workers to address ongoing innovation-related issues mutually.

Why hospital costs are soaring

Canadian hospitals may have to be much more selective in their adoption of state-of-the-art medical technology, in order to bring their rising costs under control.

As well, policy makers should be seriously considering alternative methods of delivering hospital care to prevent these costs from getting out of hand, says economist Ludwig Auer in a research study written for the Economic Council.

Auer carried out an extensive analysis of changes in Canadian hospital costs and productivity between 1960 – a few years after a new Act of Parliament had provided Canadians with guaranteed access to hospital services – and 1980. His study takes into account over 90 per cent of all hospital beds in Canada and is based on hospital data provided by Statistics Canada and by Health and Welfare Canada. In conducting his research the Council economist experimented with various approaches to the measurement of output and productivity – an area of great concern to economists because of the growing importance of the service sector in the economy.

At the outset, Auer acknowledges that Canada's health care system "provides ready access to high quality care for all Canadians" at a reasonable cost, by international standards. He warns, nevertheless, that costs have been rising steadily over the years, in no small part because of rapidly increasing hospital expenditures – which grew at an average annual rate of 15 per cent between 1960 and 1980, and which accounted for 40 per cent of the rise in total health costs.

Reason for rise

Auer examines in turn the possible explanations for this alarming increase: growth in population, admission rates, higher wages and prices, and/or variations in hospital care.

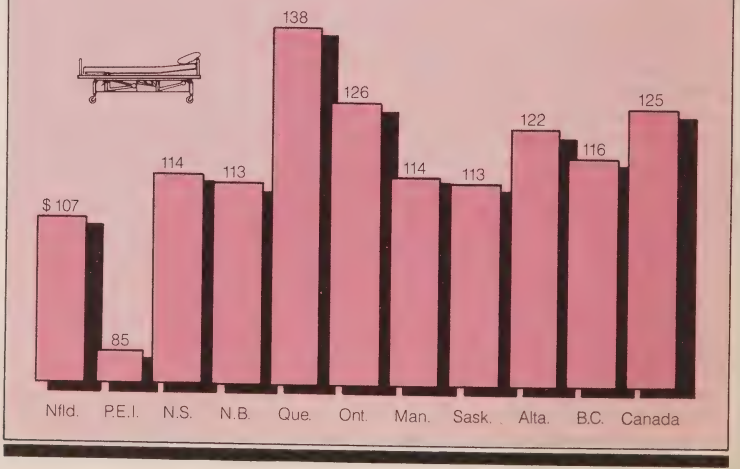
Only one-tenth of the rise was attributable to population growth, he found. An increase in the number of elderly, who require more hospital care, was offset by the lower admission rates for young women, caused by the sharp reduction in birth rates.

While the rate of hospital admissions changed very little, however, the costs per admission climbed steadily, primarily because of the higher wages paid to hospital staff. But a noticeable increase in the services provided by hospitals also pushed up costs. Auer attributes this higher service volume to two things: a surge in the number of services – nursing, administrative, and diagnostic/therapeutic – provided for each patient (which he terms "case intensity") and an increase in the number of personnel hours and materials required by each service unit ("task intensity"). A good example of case intensity, he notes, is found in the higher number of radiological examinations and treatments carried out over the period. Greater task intensity is evident in the longer hours that nurses spent with patients. A striking example is in obstetrics, where nursing hours per delivery almost doubled over the 1960-80 period – an increase associated with the doubling of the rate of caesarean births between 1972 and 1981.

This intensifying of services accounts for the slow productivity growth between 1960 and 1980, Auer says. Using a variety of measures, his estimates range from an annual decline of

Hospital spending varies among provinces

Total hospital operating expenditures per capita, 1961-79/80



2.3 per cent to an annual growth of 0.9 per cent. Only if the benefits to the patient prove commensurate with the increased services, can productivity be said to have improved, he argues.

But the jury is still out in this regard, Auer claims, citing as a prime example the widespread use of expensive "halfway" technologies and treatments that provide comfort but not cures. (Expenditures on the terminally ill are a prime example.) Given that cost restrictions will probably compel hospitals to be far more selective in patient treatment, "there is an urgent need for a cost/benefit evaluation of surgical interventions, alternative treatments, and associated hospital costs," Auer concludes.

Provincial comparisons

Auer also examined provincial differences in hospital spending and productivity. He found that operating expenditures varied by as much as 40 per cent (see chart) primarily because of variations in admission rates – which ranged from 25 per cent below to 25 per cent above the national average in Quebec and Saskatchewan, respectively.

Interestingly, Auer observes, those provinces with lower admission rates recorded higher levels of service intensity – and thus higher per-patient costs. (Saskatchewan and Quebec are almost mirror images in this regard.) "It is tempting to conclude," Auer surmises, "that costs per patient and admission rates were not independent of each other, but that higher admission rates were linked with lower costs per patient and lower admission rates with higher costs."

Determining differences in hospital productivity across the provinces proved to hinge on the choice of output measure, Auer found. When hospital output is measured by the number of patients, for example, Quebec proved to be the least productive with an average of 12 patients per staff person-year; Prince Edward Island was the most productive, with 21. But when output is measured by the volume of hospital services provided, the reverse proves to be the case.

Finding solutions

Bringing hospital costs under control will require productivity improvements, Auer concludes. In other words, hospitals will have to be more efficient in their delivery of services of the same or better quality.

Auer describes several methods that might serve to achieve this goal. One option is a new system of accounting and payment schedules based on diagnosis-related groups (DRGs) currently being introduced in the United States. Under this approach, average treatment costs are set for a long list of DRGs. When the actual cost of treatment is lower, the hospital can retain the difference; when higher, it must record a loss. Auer cautions that this method has some shortcomings but argues that it would be useful in cutting down on excessive hospital treatment.

Another option is the use of a prepaid health care system, whereby individuals or companies would pay an annual sum for guaranteed health care. Again, there would be some drawbacks to using that system in Canada, but Auer suggests trying it out in targeted areas to test its efficacy.

Finally, Auer stresses the need for cost/benefit evaluation of hospital treatments, and he advocates the development of new labour-saving technology – an area that has attracted little funding to date.

Canadian Hospital Costs and Productivity, by L. Auer (EC/22-138/1987E; $8.95 in Canada, $10.95 elsewhere).



Debunking unemployment myths

Misconceptions about the nature of unemployment and its causes could frustrate attempts to help Canada's jobless, says a leading authority on the subject.

Claude Forget, head of the recent Commission of Inquiry on Unemployment Insurance (the Forget Commission), says that poor analysis of the unemployment problem threatens to lead policy makers "down the wrong track" in prescribing solutions. Speaking at a recent Economic Council seminar, Forget outlined the main findings of the Commission report and challenged some of the major assumptions about unemployment in Canada.

Finding the causes

For example, the lack of job opportunities in many isolated regions of the country is perceived to be a key cause of high regional unemployment. To help deal with the problem, the unemployment insurance program is tailored to reflect regional circumstances. But location may not be the most significant factor contributing to the regional variation in unemployment rates. Instead, the age of the unemployed, sex, education, occupation, and industry, as well as the rural-urban mix, may account for much of the difference. Consequently, new programs that go to the root of the problem would probably do more good than an increase in unemployment insurance benefits, Forget says. "Giving more money to a region where poor education contributes to unemployment certainly won't solve the problem," he explains. "I question whether the regional factor contributes to unemployment as much as we tend to think it does. Let's dig a bit deeper, do more analysis. By focusing on the regional factor, we tend to see income transfers as a remedy for income disparities. But there are deeper causes that can and should be addressed."

Forget also questions the assumption that unemployment is a problem belonging chiefly to lower-income groups. In fact, well-to-do Canadians are almost equally at risk. In about 8 per cent of the families with the top 1 per cent of income, for example, at least one family member experienced unemployment in 1981, compared with 12 per cent for average-income families. Moreover, less than 9 per cent of the unemployed became social assistance beneficiaries once they exhausted their unemployment insurance benefits. "This seriously challenges the propriety of using unemployment insurance as an income-redistribution vehicle," Forget says.

Growth in jobs

Canadians have been led to believe that relatively high unemployment in recent years has resulted from a significant deterioration in Canada's employment prospects. In reality, says Forget, there has been healthy growth in the job market. About 60 per cent of Canadians held jobs in 1986. That is within half a percentage point of the highest employment ratio on record, which occurred in 1981.

As for reforming the unemployment insurance program, Forget expressed confidence that much of the Commission's outlook will eventually have an impact on policy. He says the report offers "a moderate alternative" to other suggestions put forward in the debate so far, despite the controversy over the minority view expressed by dissenting members of the Commission. And while it will take some time to implement the changes because of the complexity of the system, "there are a number of factors at work that will facilitate change," he says.

For one, the pent-up frustration and dissatisfaction with the program among Canadians "is a potent force that will not disappear," Forget insists. The program is now so complex to administer that claims officers routinely process less than 10 claims a day as opposed to about 60 a decade ago, he says. The cost to administer the program now exceeds $900 million a year (excluding the benefits paid to unemployed workers).

Second, the provinces share a common interest with Ottawa in reforming the entire income-security system. Without mutual concurrence, neither party can make significant changes even to programs they directly control. Finally, the impending debate over tax reform provides an opportunity to bring in needed improvements in social policies.



New Director discusses Council

Last March, Caroline Pestieau was appointed as one of the Council's two full-time Directors. A graduate of McGill, Louvain, and Oxford universities, she had served as Commissioner of the Quebec Access to Information Commission since 1983. Before that, she worked at the C. D. Howe Institute as a research economist, senior economist, Director of Research Studies, and Head of the Montreal office. While at C. D. Howe she was Project Manager of the Accent-Québec program, which produced 14 studies on the Canada-Quebec economic relationship. She is also the author of several studies in the areas of industrial and commercial policy.

In the following interview with *Au Courant*, Pestieau discusses some of her views of the Council.



Caroline Pestieau

***Au Courant:** Which direction would you like the Council to take in the next few years?*

Pestieau: Well, I think there are several different ways of looking at direction. As far as research is concerned, I'm pleased with the directions we've been taking in the last 18 months or so. I'm very glad that we're able to do something on agriculture because I think this problem is underestimated outside the Prairie provinces. I think we're going to have to continue looking at trade adjustment, and I think we're going to have to give a lot of importance to the service economy – both domestically and internationally. As for how we go about our business, I think the Council needs to strengthen its communications with different clientele across the country, particularly provincial decision makers. In fact, we've already started doing this in the agricultural field and in the social-policy and tax fields.

***Au Courant:** What other clientele should we be dealing with at this point?*

Pestieau: I think we have to try to cover the waterfront, which is very difficult. We need to strengthen relations with the legislators in the 11 governments, and particularly with the Finance Committee of the House of Commons. At the same time, we have to renew relations with the business and labour communities. Of course, there are also the federal and provincial bureaucrats, so we've got a lot of bases to cover.

***Au Courant:** From a personal point of view, what do you hope to contribute to the Council?*

Pestieau: It's difficult to say at this stage. I see my role as a coordinator and communicator in helping to make the results of the Council's research understood and widely available. I see it as working very closely with the research groups to build on the policy implications of their findings. I think that the Council's empirical findings are gold mines; but, too often, the fuller policy implications of its research are not fully exploited. So I hope to have a kind of bridging function between the people who are desperately trying to understand the key economic issues and the resources we have at the Council to identify and elucidate them.

***Au Courant:** What major economic issues should the Council be addressing?*

Pestieau: Well, I've referred to the agriculture one, which I think is extremely important. I think we're going to have to do quite a lot of work on services. We've just launched a project on international financial services, in fact. We're going to have to concentrate more and more on looking at trade in what were once considered nontradeable goods, such as business and professional services via computer-linked telecommunications. We should also be studying the economic implications of demographic changes, the changing age structure, and the dependence on immigration in certain areas of the country. Above all, I think we're going to have to look at the labour force, particularly the development of human capital because of its importance in helping Canada to compete in a rapidly changing global environment.

***Au Courant** What insights has your extensive background in Quebec provided that might be useful in discussions with that province?*

Pestieau It's given me insight into the way that different regions of Canada can experiment. Quebec has been experimenting in several areas – social policy, tax incentives, and so on. One example on the investment side is the Quebec stock savings plan. I believe it's healthy and important that different regions be encouraged to experiment in policy development, so that others can adopt what works and reject what doesn't. I think the Council has to be more present in Quebec, and I hope that I may be instrumental in this regard. The Council has to address problems that are of interest not only to Quebec bureaucrats but also to Quebec management and to the various labour movements in the province. I would hope that the Council would be able to organize round tables and seminars to exchange ideas on major issues with Quebecers.

S·P·E·A·K·I·N·G · O·U·T

Canada's economy has been growing at a steady pace over the past few years, but the growth figures mask a dismal performance in some regions.

In Newfoundland, the unemployment rate remains at about double the national average; in Saskatchewan, farmers are reeling from the drop in grain prices; and in Alberta, oil revenues are drying up. Regional disparities have persisted in Canada despite government attempts to encourage regional economic development. In fact, many observers argue that Canada's regional development policies are in disarray. In response to this situation the Council has launched a new project to examine directions for regional development and to put forward policy options. *Au Courant* spoke with project director Dal Brodhead to find out what the project entails.

Au Courant: Why is the Council undertaking this project now?

Brodhead: I think there's fairly widespread agreement that Canada's regional policies are outdated and need rethinking. Governments are already involved in that process. The Council has a unique opportunity to make a contribution as a national organization reflecting regional and sectoral interests. There's no doubt that for Canada, as a whole, regional economic development is crucial. We need a policy that can address the unique concerns of the different regions. That's quite a challenge.

Au Courant: Are regional disparities getting worse?

Brodhead: I think there's a perception that things are getting worse, and in some cases it's true. In Newfoundland, for example, there continues to be high unemployment. In Saskatchewan, the agricultural economy is quietly going up in smoke for a host of reasons, some of them well beyond the boundaries of regional or national jurisdiction. In Ontario, on the other hand, the economy is generally in pretty good shape. So the contrast is quite sharp in some cases, and the



Dal Brodhead

relative regional disparities remain just as great as ever in spite of all the past efforts.

However, I think it's important to look beyond the current situation. Perhaps the regions that are thriving today won't be so prosperous tomorrow; perhaps the foundations for growth are weak, and hence we have a much broader problem to address in this country. Part of the objective of this study is to identify promising approaches and areas of strength upon which we may build.

Au Courant: In the past, how effective have government policies been in combatting regional disparities?

Brodhead: Some of the programs have had significant impact, particularly in terms of putting together the infrastructure necessary for regional economic development. In the 1970s, the federal and provincial governments undertook a major thrust in regional economic development. Some of these initiatives were successful, but conditions have changed. There is the view that we've been concentrating too much on either macro regional development or on smaller-scale individual entrepreneurial projects, to such an extent that we are missing out on a whole range of opportunities in between. There is the issue of access to capital: how regionally accessible and how risk-averse is it? Under the centralized banking system in this country, local branches don't necessarily invest in their communities, and there is an apparent lack of development capital in the less prosperous regions and communities.

Au Courant: In the final analysis, is there really a solution to the "boom and bust" cycles of a resource economy such as Canada's?

Brodhead: It depends on whether you subscribe to the view that our economy has to be forever based on the exploitation of our natural resources or whether it can be strengthened by diversifying into other areas, such as the service sector. The main thrust of this project is to take a look at some of the innovations that have been taking place at the community or local level throughout Canada. Basically, we'll be looking at the key ingredients of success in the rebirth of selected communities that have managed to overcome a trend toward economic stagnation. In many cases the success seems to have been linked to a whole range of smaller developments that are less flashy than the costly efforts to develop megaprojects.

I think we have to get back to basics, to talk to the people at the community level who can tell us which projects have been successful and which ones have been instructive failures. The definition of success should have more to do with what the people in the regions feel than with any kind of national overview that we can come

There's fairly widespread agreement that Canada's regional policies are outdated and need rethinking.

up with here. We're not really engaging in successful regional development if we improve a company's profit record without doing anything for the quality of life in the community concerned, perhaps by improving its capacity to survive in the long run.

By talking to people at the local level we can come up with a better sense of what we've learned about regional development over the past while. Therefore it's important that we engage in extensive consultations with different groups and individuals, some of whom may not have been consulted in the past. After the project has been completed and the files have been put away, we hope to leave behind an increased awareness of what regional development is all about, to leave people better equipped to engage in regional development, and to improve its policy formulation in the future.

Au Courant: What approach will you be taking?

Brodhead: Most of the work will be done outside Ottawa. We'll have four regional coordinators who will discuss with people in the regions the development initiatives that have been undertaken in the past, which will help us to construct guidelines for a national policy on regional development. We're not talking about high-profile consultations but, rather, low-key discussions involving the people who've been involved in the practical side of regional development – business groups, community leaders, labour groups, and the cooperative movement, for example. There will be some research done in Ottawa as well. I'm hoping, too, that we'll have the capacity to link up nationally through a computer-assisted communications network. Not only would this save time and travel costs, but it would permit other groups across the country to interact with us.

Au Courant: What sort of policy options do you expect to put forward?

Brodhead: It's a little difficult to second-guess what we're going to be saying in the final report, partly because we haven't yet had the consultations that are fundamental to the approach we're taking. Nor have we reviewed the massive amount of literature on regional development. But I could see the possibility of more emphasis on helping communities identify their options and opportunities, and providing them with the support needed to encourage regional development, rather than simply concentrating on trying to woo a major manufacturer into a region with an incentive grant, for example. We'll be looking at the Canadian as well as the U.S. experience in this regard. Then we'll be able to develop some policy options.

By talking to people at the local level we can come up with a better sense of what we've learned about regional development.



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Economic Council of Canada Volume 8 No 2, 1987

The Council's Annual Review of the economy



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PUBLICATIONS

Twenty-Fourth Annual Review

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Reaching Outward



Canada has legitimate grounds for pursuing its own cultural and social policies, as well as regional and industrial development, under a free-trade deal with the United States, the Economic Council says in its Twenty-Fourth Annual Review of the economy.

The Council says that any pressure to harmonize these policies as a result of either the trade talks or protectionist U.S. trade legislation must be resisted. Given the importance of cultural development to Canadian identity and nationhood, the Council observes that government intervention to ensure some minimum level of Canadian content "may be deemed essential." As for Canada's social programs, it says there is "no legitimate basis . . . for the United States to attempt to force them to the negotiating table," since those programs "do not involve trade-diverting subsidies." Similarly, regional support initiatives that are intended to redistribute jobs and incomes within Canada are not "legitimate targets" for U.S. trade actions, it argues.

One way or another, the next year will be a major turning point in Canadian history, the Council says. If a Canada-U.S. trade accord is implemented, it will require major adjustments. But it also promises sustained benefits. If no trade deal occurs, Canadians will have to rethink seriously their approach to commercial policy and to international diplomacy.

The Council is struck by the degree to which national economies are becoming increasingly integrated and by the relative decline in the economic leadership of the United States. The first development includes growing pressure on governments to harmonize their laws governing commercial transactions. In the second instance, U.S.-led economic growth is showing signs of faltering because of the huge trade imbalance and massive government debt in that country. The Council warns, in fact, that the prospects of the U.S. rectifying its trade imbalance without resorting to protectionism are not "especially strong," unless the industrialized world can sustain growth of about 3 per cent annually over the next few years. But such growth may require strong fiscal initiatives on the part of major surplus nations such as Japan and West Germany. So far, neither country has shown sufficient willingness to respond in this regard.

In contrast to the growing protectionism on the trade front, there is widespread liberalization taking place in most of the world's major financial centres. Investment capital is increasingly mobile internationally. Governments have been forced to recognize that autonomy over economic policy is clearly limited, the Council says. It suggests that, at a minimum, leading industrialized nations "explore systematically the options that exist between the two extremes of fixed and floating exchange rates." Similarly, coordination and action are required to help the less developed nations work off their debt burdens in ways that will not destabilize the international financial system. The price of limited action to date has been a deterioration in the financial health of debtor countries and a major constraint on world trade.

In this environment, one of the key objectives for economic policy, in the Council's view, is to make the economy resilient enough to withstand unfavourable shocks from abroad – such as low commodity prices, for example. At the same time, the Council believes that Canada is well placed to seek out and compete in new markets. In fact, it has already demonstrated its capacity to trade with Japan and the newly industrialized nations. Moreover, the realignment of the Canadian dollar in relation to the Japanese yen and to European currencies has enabled Canada to increase exports to those markets. Even though Canada lags behind other countries in the use of robots, computers, and process technologies, it is ahead of most others in its application of satellite communications, remote sensing, optic-fibre networks, and other basic technologies. Canadian businesses now attract capital from around the world; with it comes new technologies and expertise that enhance competitiveness. The Council also notes that Canada is "a young and informed society." Proportionately, for example, it has more young adults in full-time postsecondary programs than any other industrialized nation except the United States.

On subsequent pages the Council describes its medium-term economic outlook against this background. It also examines the growing pressure to harmonize policies across the Canada-U.S. border, with special attention to subsidies, health care, and cultural industries.

Outlook for the economy

The Council's main projection of the key economic indicators – which it calls the "base case" – is founded on certain specific assumptions (on the past performance of the economy, for example, as well as its present position; on current information about its future course; on the outlook for foreign economies; and so on). Using this basic projection, the Council then tries out various scenarios or alternative cases to see how the economy would be affected.

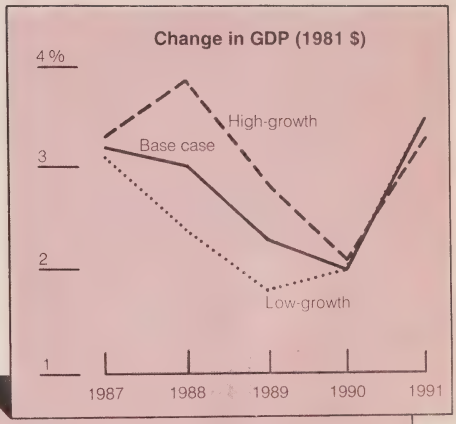
At the moment, central Canada is enjoying an economic boom, triggered primarily by last year's fall in oil prices and interest rates, as well as the exchange-rate realignments that have made Canadian products more competitive in Europe and Asia. Increased exports to the United States have contributed to the recovery as well. The result has been a sharp drop in unemployment in the industrial centres of southern Ontario and Quebec, and a decline in the personal savings rate as Canadians have become more confident about the future. As well, government revenues (especially in Ontario) have increased in response to higher incomes and sales.

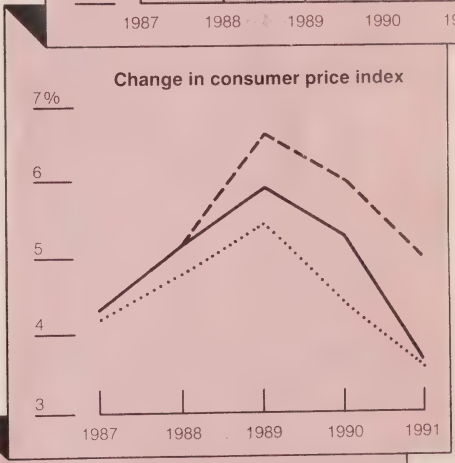
But the recovery has been slow to work its way through to other provinces. A revival in the oil sector will help western Canada and possibly parts of the Atlantic region; but the glut in agriculture, depressed metal prices, and the uncertain availability of adequate fish stocks, among other things, will affect the future prosperity of those regions.

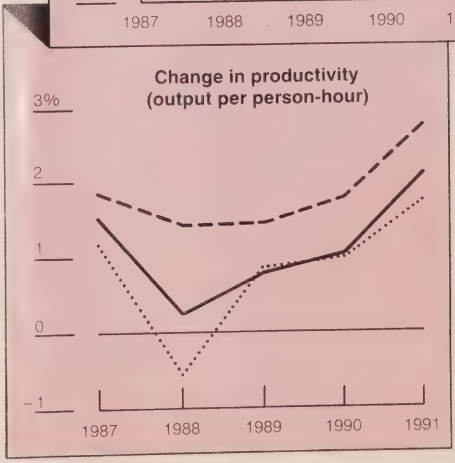
The Council singles out three problems that deserve special attention over the next while: unemployment; debt burdens; and productivity growth. Unemployment remains unacceptably high in the resource-producing regions of the country, it says. The federal government's fiscal position is still tenuous, despite several years of rigorous spending restraint. The widening gap in manufacturing productivity between Canada and the United States is worrisome as well, because this sector is the most exposed to international competition.

The Council recognizes that the choice of policies used to tackle regional imbalances is limited by fiscal constraint. The Bank of Canada faces a dilemma, too, because there is no mechanism to differentiate monetary policy among regions where economic performance diverges. In this sense there could be the risk, for example, of precipitating inflation in central Canada while the rest of the country is still struggling to get out of the recession.

In the Council's view, the medium-term outlook is plagued by uncertainties, depending to a considerable extent on the way the industrialized countries work out the current imbalances in trade and capital flows. By far the most important factor to watch is interest rates, followed by the outlook for the U.S. economy, the possibility of a Canada-U.S. trade deal, and the impact of recent tax-reform proposals in Canada. The Council's base case calls for the continuation of steady growth for Canada as a whole until 1989, but wide disparities in regional growth rates will still exist. By the end of the decade, Canada will still have some distance to go







before a reduction in unemployment and deficits, as well as growth in productivity, will enable it to deal undeniably from a position of strength.

Real growth is estimated to average 2.8 per cent during the 1987-91 period. The year 1988 will be a bit stronger, with growth at 3 per cent. In the following two years, however, economic performance is expected to be below average, reflecting, among other things, a weakening of the external sector and a tail-off in the investment cycle. In the Council's high-growth scenario, real growth is expected to average 3.1 per cent over the next five years. Both the unemployment rate and the government deficit as a percentage of gross domestic product (GDP) show modest improvement, as do other indicators. In the low-growth scenario, real growth averages just over 2 per cent; in this case, the growth is weak enough during the 1988-90 period to cause new damage to deficits and unemployment rates.

Inflation is expected to average just below 5 per cent in the base case, peaking at 5.9 per cent in 1989. Its level will be affected by the recovery in oil prices, the expectation of a U.S. inflation bubble, a tightening of labour markets, a bottoming-out of commodity prices, below-average productivity performance, and some upward pressure on the growth of nominal wages.

Employment growth in 1987-88 should be strong, following the pattern of real growth; but it will slip below 2 per cent in the 1988-90 period, when real growth weakens.

Productivity growth (output per person) is expected to advance at a rate slightly above 1 per cent annually. The Council expects strong productivity performance in 1987 and that it will strengthen again as the economy recovers from the 1990 growth pause. A poorer performance during the intervening years contributes to upward pressure on unit labour costs, adding to the inflationary strains in 1988-90.

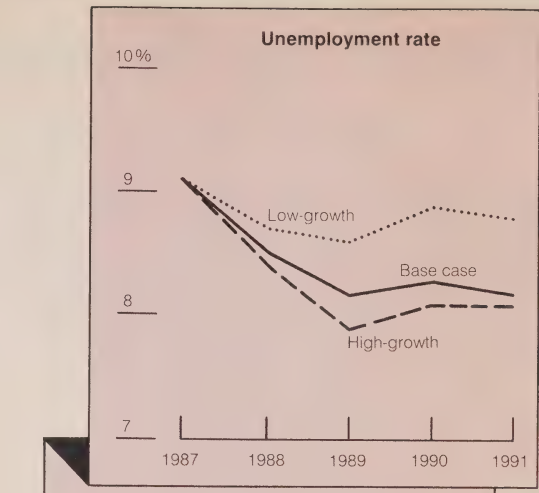
After a long drought, growth in real wages recovers during the 1989-91 period. Nominal wage growth will average about 5.3 per cent but exceed the 6-per-cent mark in 1989-90.

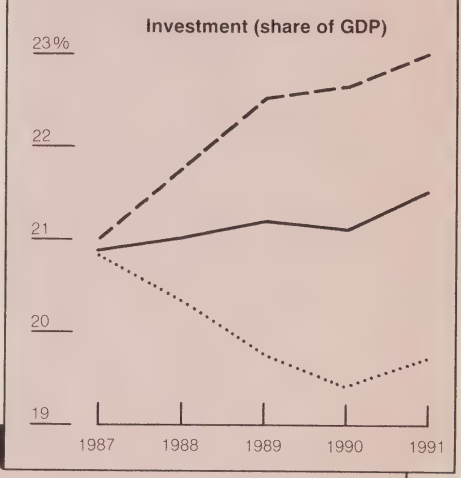
By the end of the decade the unemployment rate declines to just above 8 per cent, while averaging 8.5 per cent over the 1987-91 period. The decline is interrupted by the period of slow growth in 1990, after which a strong recovery nudges the unemployment rate downward again.

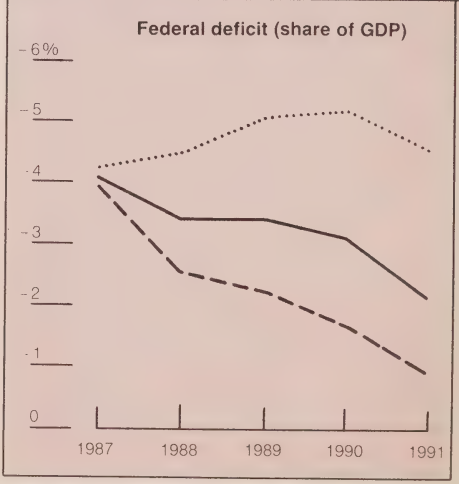
Investment is expected to be one of the engines of growth during the 1987-91 period. The origin of this strength will be the current surge in new housing construction, sustained growth in machinery and equipment purchases, and more spending in the energy sector.

Canada's current-account balance of payments remains in deficit throughout the projection period. A weakening of external demand, a bubbling-up of domestic inflationary pressures relative to external market conditions, and a weak automobile market all contribute to the deterioration in 1987-89.

No substantial improvement in the ratio of the federal deficit to GDP occurs until 1991, despite assuming sustained expenditure restraint. After the growth pause, a strong performance pushes it down to 2.1 per cent. If there are unforeseen expenditure increases or revenue shortfalls, however, little or no improvement can be expected.







External pressures on domestic policy

Many of Canada's unique institutions and programs will be potential trade irritants unless there is an easing of protectionist sentiment in the United States, the Council warns.

It looks at three areas in particular: subsidies, social programs, and cultural industries.

On many occasions the Council has questioned the proliferation of subsidies and other government interventions in the economy. While agreement among governments as to the definition of "fair subsidies" will be difficult, the Council suggests retaining the definition applicable under the countervailing provisions of the General Agreement on Tariffs and Trade (GATT). It distinguishes between government support that is available on a universal basis and that which is applied selectively to shore up specific industries or firms. Under GATT rules only the latter are considered "countervailable subsidies" (where a country can, for example, impose import duties to offset the effects of the subsidy). The Council also says that it is not unreasonable for U.S. authorities to exert pressure in instances where, for example, Canadian public policy is aimed principally at shifting production and jobs from the United States. But when public policy has as its principal focus other national objectives – social concerns, cultural development, and the alleviation of regional disparities, for example – "these items are not cards that need to be played in a trade negotiation," it argues.

Even with an agreement on the definition of "fair subsidies," however, the U.S. Congress may retaliate in other ways. For example, it could argue that most of Canada's major social programs (health care and social security) lead to unfair competition. That's because they are funded largely from general tax revenues, while in the United States the funding comes primarily from payroll taxes or premiums levied directly on employers and employees. The result is that Canadian employers have much smaller payroll costs. Corporate taxes, as well as personal taxes, are higher in Canada, however, in order to finance its social programs.

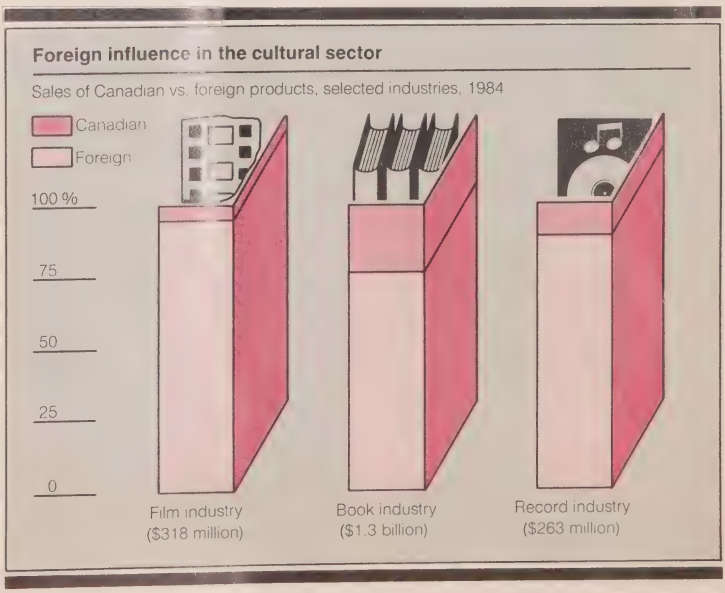
Regional and industrial incentives

Canada has had a long tradition of using federal government programs to encourage growth in the less advantaged regions, to reduce income and employment disparities among regions, and to make available a basic level of services that is relatively uniform across the country. In general, the Council is "not much enamoured" with many of them. In a forthcoming document it will report on three trade-related adjustment programs in particular: the Pulp and Paper Modernization Program; the Shipbuilding Industry Assistance Program; and the Canadian Industrial Renewal Board. In each instance the Council finds that government intervention is "largely unwarranted," with the possible exception of labour-adjustment assistance.

Generally speaking, should these types of programs be aimed at relocating investment and employment in order to reduce regional disparities in Canada, they need not be subject to international negotiation. Should they be aimed at attracting investment that would not otherwise be economic in the longer term, however, they become a legitimate item for international negotiation.

Unemployment insurance

A chronic complaint of the U.S. fishing industry has been the existence of special unemployment insurance provisions that assist Canadian fishermen. But the worry here has less to do with the possibility of countervailing action than with the broader pressures that might be applied to harmonize the two countries' systems. In the Council's view, "Canadians are not willing to see the program gutted or to give up regional or other portions of it unless there is a viable alternative put in place." It notes that



85 per cent of the jobless in Canada receive benefits, while in the United States roughly 75 per cent do not. (Because they are out of work, the U.S. jobless have no medical coverage either.)

Health care

Through its 10 provincial governments, Canada has a comprehensive health care system that is much admired internationally, the Council asserts. On a per-capita basis, taking all public and private spending into account, health care in the United States costs about one-third more than in Canada. In some cases the same operation costs three to five times more in the United States than in Canada. Irrespective of hospital costs, the largely privatized U.S. health care system is more expensive partly because of the higher number of physicians per capita and their generally higher salaries. Liability insurance is much more expensive there as well. Meanwhile, the U.S. Institute of Medicine reports that some 35 million Americans do not have medical insurance, and the disparities in access to health care are getting worse. While private U.S. institutions devote considerably more resources to research and are at the forefront of medical skills, Canadians "clearly are not prepared to give up the health care advantages they now enjoy," the Council believes.

In general, publicly funded programs that are directed at redistributing income and economic activity across regions or at insuring against illness, accident, or job loss are common to most industrialized nations, the Council notes. For that reason they have been excluded from the GATT definition of countervailable subsidies. "In short, there is no case to be made for countervailing action against Canada," it concludes.

Cultural issues

The Canada-U.S. free-trade talks have intensified concerns about Canadian cultural sovereignty with respect to content, production, and ownership. (Only the commercial culture industries are at issue, including publishing, radio and television production, film making, and sound recording.) While Canadians are ardent consumers of cultural products and services, many of these are imported. The accompanying chart shows the degree of foreign influence in the film, book, and record industries, for example.

Because foreign-owned subsidiaries handle the sale and distribution of most imported cultural products, Canadian-owned enterprises are chronically underfunded. As a result, commercial lenders are wary of lending them capital. Moreover, with the trend to major corporate takeovers and mergers in the United States and Europe, the competitive environment is changing, to the disadvantage of Canadian producers. The fear is that in an unregulated free-trade situation the financial power and sophisticated marketing and distribution strategies of these multinationals "could well marginalize Canadian cultural products within the Canadian marketplace," the Council says.

> *Canadians are clearly not prepared to give up the health care advantages they enjoy.*

Because of the size of markets in the United States and the United Kingdom, they are able to command products that reflect their unique cultural experiences, regardless of the ownership of the enterprises that operate there. "The same is not true when foreign-controlled firms operate in Canada," the Council maintains. Still, in the current trade negotiations, ownership should be of concern only when it limits Canadian content and competitiveness, it says.

Canadian governments have erected several trade barriers to further Canada's cultural development. These include legislation that prohibits foreign ownership of Canadian television, radio, and cablevision stations; Canadian-content regulations; and postal subsidies that provide a cost advantage to Canadian periodicals. Such intervention may imply an economic cost to Canadians. "Given the central importance of cultural products to Canadian identity and nationhood, however, we can accept that such decisions may be deemed essential," the Council concludes.

At the same time, policies to support domestic content and sales are a matter for case-by-case consideration. In fact, says the Council, "Canada may find it necessary to seek out forms of support for culture that minimize distortions to trade."

Trade adjustment

To illustrate the effects of Canada-U.S. free trade on the Council's base-case projections for the Canadian economy, the Council developed two scenarios. The results of these simulations were initially published in a separate discussion paper (see page 9 of this issue). In the Review, the Council provides additional information on trade adjustment.

For example, it finds that workers initially laid off as the result of a free-trade deal would generally have little difficulty finding work. That's because the job losses from free trade would be concentrated in the same occupations in which job gains would be the greatest – clerical, product fabrication, processing, service, sales, and management. The high degree of labour mobility between occupations and industries in Canada would make the adjustment process easier as well. But a significant number of women now working in textile and knitting mills in some of the small towns of Ontario and Quebec could be forced to find new jobs, the Council warns. At the same time, though, female workers generally would benefit more from trade liberalization than males.

Each year under bilateral free trade about 66,000 jobs would be created and 23,000 lost. But the job losses would represent less than 2 per cent of normal permanent displacements in any given year, the Council points out. Similarly, the adjustment pressures that firms and industries would face in adapting to the larger North American market would be modest compared with normal competitive pressures. In the Council's view, Canada would not need special programs to help displaced workers adjust to trade liberalization. But it calls on governments to focus on the training needs of individuals and on the smooth functioning of labour-market information systems to ensure that placement services work efficiently. The Council's recommendations in its recent study of the impact of technological change on labour markets (see *Au Courant*, vol. 8, no. 1) should apply to workers displaced by trade as well.

Options for the future

A free-trade deal with the United States must satisfy Canadians on a number of fronts, the Council says.

In providing freer access to U.S. markets, it must take account of state and local, as well as federal, barriers. It must clearly identify areas of policy, trade, and investment that are non-negotiable, as well as the domestic institutions, laws, and regulations that are beyond the reach of countervailing action. It must contain clear definitions of subsidies that are countervailable and those that are not. These definitions should be in keeping with the spirit of the current definitions under the General Agreement on Tariffs and Trade (GATT). And, finally, the accord should contain a dispute-settlement mechanism that would deal with trade irritants quickly and impartially.

Failed negotiations

Failure of the negotiations would be unfortunate, the Council says, but it need not be catastrophic. Almost 80 per cent of Canadian exports to the United States already enter duty-free, while the remainder bear average duties of less than 7 per cent, it notes. Should the negotiations fail and should the United States pursue its own unilateral trade policy more or less independently of GATT, two options are possible. One is to take a defensive stance, countering restrictive trade action with restrictive trade action, in a series of mutually self-defeating disputes and rounds of nationalistic posturing. The other is to turn outward, using aggressive marketing and a combination of lobbying and proactive diplomacy to strengthen the multilateral commitment to trade liberalization.

The defensive option would involve a period of severe economic stress and would probably result in substantial losses for Canada. The outward option would require a much more far-sighted and aggressive commercial policy, with Canada sounding the alarm about the risks of protectionism; encouraging Japan, West Germany and the United States to make a more serious commitment to the current round of multilateral negotiations; and pressing hard for an agreement to stop the addition of new trade barriers during the GATT negotiations. If relations with the United States are not seriously impaired by the failure of the talks, Canada would also form a common front on such issues as agricultural subsidies, trade in services, and possibly intellectual property.

TARGETS

1 — Employment growth of 2 to 3 per cent a year in order to lower unemployment to a range of 6 to 8 per cent by 1990.

2 — Productivity growth of 1.5 to 2.0 per cent a year.

3 — Annual inflation of 5 per cent or less.

4 — Net capital inflows of about 2 per cent of GNE or less.

5 — The maintenance and improvement of existing social policies.

6 — A gradual reduction of the federal deficit to an easily manageable level.

7 — Regionally balanced growth, employment opportunities, and social infrastructures.

Increased lobbying

Canada should push forward on two other fronts as well: increased lobbying in Washington, in order to forestall as many protectionist actions against Canada as possible; and more aggressive promotion of Canadian exports, especially in countries on the Pacific Rim. "In short, the alternative to Canada-U.S. free trade will not be the status quo but a tough and combative international marketplace," the Council says.

The spectre of protectionism aside, the Council sees much on the horizon that gives cause for optimism. Canada has survived the worst recession since the 1930s, along with a severe drop in commodity prices that now seems to be bottoming out. The commercial sector is leaner; financial institutions, more solvent. Business investment is picking up. Unemployment is falling, even in the most severely affected regions. Recent government initiatives appear to be strongly supportive of economic growth, including changes in the financial sector, tax reform, regional initiatives, and the trade talks.

Over the past few years the Canadian economy has been moving closer to the targets set for it by the Council in the past (see box). But it is unlikely that the targets for productivity growth and reduced unemployment will be met by 1990. For its part, the federal government has been pursuing a policy of spending restraint without engaging in vigorous slashing of social policies and entitlement programs. "In our view, that is the right course," the Council says. But the vulnerability of the federal fiscal position to an early downturn in the economy underlines the need to make as much progress as possible on deficit

reduction while the economy is still relatively healthy.

Regional balance

Moreover, Canada's major problem over the next few years will remain that of achieving regionally balanced growth and employment. Since monetary policy is relatively impotent in addressing this issue, "there will be continuing pressure for federal fiscal initiatives," the Council says, at least until commodity prices recover. In this regard the creation of regionally based federal-provincial coordinating agencies should help in the design of sensitive policies to ensure that support programs are targeted at the most deserving groups and sectors.

Developments in agriculture have been particularly worrisome worldwide, setting in train a vicious cycle whereby subsidies encourage surpluses that are often dumped in developing countries, where they undercut domestic agriculture. The Council is addressing the question of the future market prospects for grain in its research on the future of the grain economy in the Prairie region, to be completed in 1988.

Reaching outward

Whether or not the lowering of trade barriers worldwide is possible, the reality is that high-income developed countries cannot compete in the manufacture of labour-intensive manufactured goods. These products are more expertly produced at lower costs in developing countries. "Increasingly, our competitive advantage will be in areas that involve a high degree of scientific and engineering skill and in which labour costs are a small proportion of total costs," the Council concludes.

Some commentators talk about a post-industrial society in which advanced nations specialize in services that are then traded for manufactured goods produced in the industrializing countries. But the Council does not share this view. Recent studies have shown that about 60 per cent of commercial activity (including wholesale, retail, financial, and other commercial services) is related to the production, transportation, and distribution of manufactured goods. "We have little doubt that manufacturing will remain a keystone activity of any medium-sized nation," it says.

The alternative to Canada-U.S. free trade will not be the status quo but a tough and combative international marketplace.

At the same time, the Council reiterates its concern that if Canada is to sustain economic growth in a globalizing economy, it "has no choice but to reach outward to new markets." The possibility of a trade accord with the United States is one route. Should that fail, however, Canada must define a role for its medium-sized economy in a world of larger trading blocs. Canadian industry must therefore gear up to compete in markets outside North America.

(In commenting on the Annual Review, four members of the Economic Council questioned the validity of the assumptions used to model the impact of free trade, as well as the results of that process. They also felt the Review should have given more attention to the problem of unemployment, the need for labour adjustment policies, and the impact of Ottawa's recent tax-reform proposals.)



The impact of a trade accord

Free trade with the United States could create as many as 350,000 new jobs in Canada by 1995, while causing only relatively few job losses in a handful of declining industries, according to new Council research.

Moreover, the gains in employment and net output from a bilateral trade deal would be distributed "fairly uniformly across all regions," says a new discussion paper by Council economists Sunder Magun, Bimal Lodh, and Someshwar Rao. Free trade would also hasten the necessary structural adjustments in the economy – the shift away from labour-intensive to high-technology industries – in order for Canada to compete "much more vigorously in the world economy in the 1990s and beyond," the authors conclude.

The Council researchers undertook two simulations to illustrate the effects of a bilateral free-trade pact on the Council's base-case outlook for the Canadian economy. In the first, all tariff and nontariff barriers between the two countries are removed (excluding agricultural and other subsidies, and trade in services). In the second, free trade is supplemented by specific productivity improvements in manufacturing industries (which result from greater economies of scale, product specialization, and so on). The work was carried out as part of the Council's Trade Policy Options and Structural Change project.

In both scenarios the impact of free trade improves real wages, increases output and employment, stimulates business investment and productivity, lowers prices, reduces government budget deficits, and strengthens the Canadian dollar in relation to its U.S. counterpart. Most of the stimulus to the economy comes from growth in consumer expenditures and investment, as a result of lower prices and production costs, and higher real incomes. The accompanying chart summarizes the major impacts of free trade on the Canadian economy.

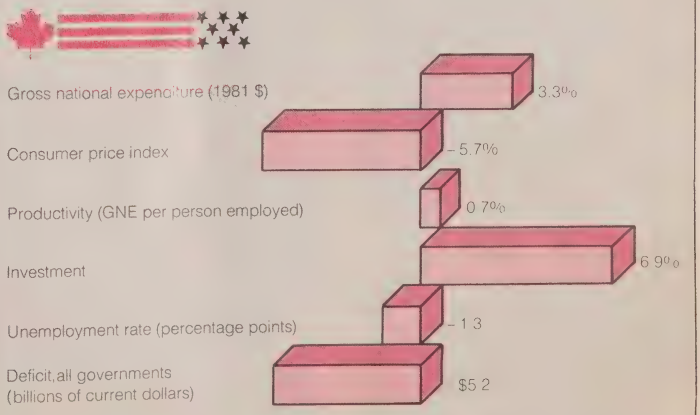
Impact, by sect

While the direct effects of trade liberalization adversely affect Canadian industries that are highly protected – chiefly in the manufacturing sector – all industries benefit indirectly from the overall increase in consumer expenditures and investment. In the first scenario, the total net impact (direct plus indirect) of bilateral free trade is positive and significant in 29 of the 36 industries examined; in the second, 30 industries record gains in output and employment.

The impact of free trade on employment, by sector, is summarized in the accompanying chart. Primary industries such as forestry, agriculture, and fishing would benefit greatly from the removal of nontariff barriers. In the service sector, four industries – retail trade; wholesale trade; business services; and personal services – would account for close to 65 per cent of all the new jobs created. The substantial gains in service-sector output and employment reflect the growing importance of services in the Canadian economy, the authors point out. All seven industries that would experience a decline in output and employment are in the manufacturing sector: rubber and plastic products; leather products; textiles; knitting mills; electrical products; chemicals and chemical products; and miscellaneous manufacturing. These industries are highly protected and already face stiff competition from low-wage

The free trade impact by 1995

Percentage and level changes over the Council's base-case projections



developing countries. The net employment reduction in those industries is about 16,000 in the first scenario, and less than 7,000 in the second. Overall, the manufacturing sector would benefit significantly from trade liberalization, with more than 42,000 jobs being created therein.

Regional impacts

To the extent that employment losses are concentrated in depressed regions and single-industry towns, free trade would exacerbate the adjustment problems in those areas, the authors explain. At the same time, by increasing overall incomes, as well as employment, in Canada, free trade would strengthen the fiscal ability of governments to provide adjustment assistance. Moreover, the gains from free trade would be fairly evenly distributed across all provinces (see chart). The Atlantic provinces, Alberta, and British Columbia would experience slightly above-average gains in output and employment, reflecting the importance of primary industries and construction in those provinces.

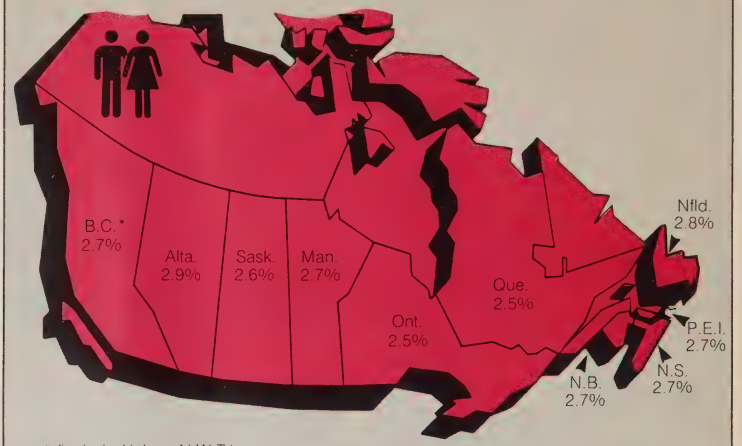
The authors caution that the size of the impacts in their scenarios depends upon the nature of free trade implicit in the assumptions and upon the structure and properties of the models used to simulate free trade. They also note that the paper's projected impacts fall within the range of all other available estimates.

As part of their free-trade simulations, the researchers provide new and more up-to-date estimates of the cost of trade protection (including both tariff and nontariff barriers) between the two countries. They find that average tariff rates (on dutiable goods only) in Canada are generally higher than those in the United States (11.2 per cent of the total value of dutiable Canadian imports from the United States, compared with 6.5 per cent for dutiable Canadian exports to that country). Nontariff barriers, on the other hand, are generally higher in the United States (1.8 per cent, compared with 1.0 per cent). The authors also develop specific estimates of the potential gains in manufacturing productivity that would likely result from a bilateral trade pact; these gains average 6.1 per cent for the manufacturing sector as a whole.

"Impact of Canada-U.S. free trade on the Canadian economy," by S. Magun, S. Rao, and B. Lodh. Discussion Paper No. 331.

The outlook for employment by province, 1995

Percentage change over the Council's base-case projections (simulation 2)

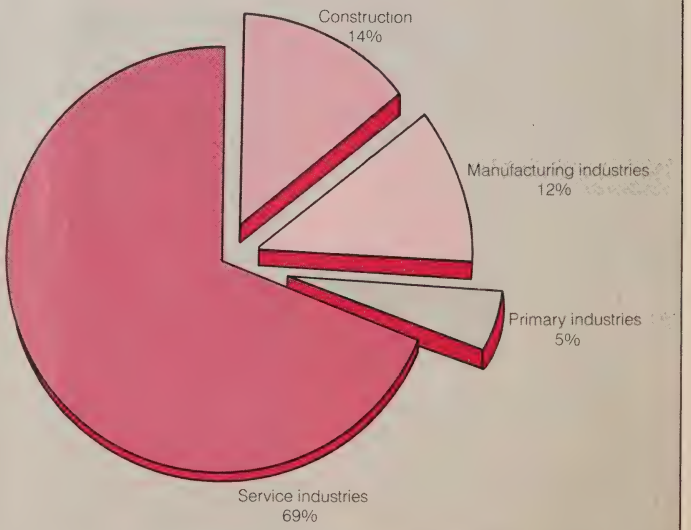


* (includesYukon, N.W.T.)



The outlook for employment by sector, 1995

Number of jobs created (simulation 2)



S·P·E·A·K·I·N·G · O·U·T

Financial markets are becoming increasingly global in scope as investors and borrowers conduct a worldwide search for the most profitable opportunities.

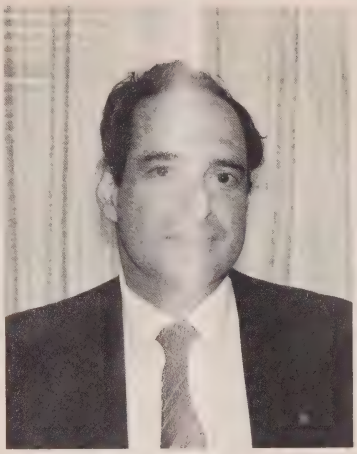
International capital flows over the past decade or so have increased dramatically. In 1970, for example, Canadian residents sold $1.3 billion of Canadian bonds and purchased $196 million of foreign bonds. In 1985 they sold $63 billion and purchased $32 billion. Between 1982 and 1985, issues on international bond markets more than doubled. Foreign-exchange trading is now a U.S.$200-billion-a-day business around the world.

In this environment, Canadian banks and other financial institutions face growing competition. Moreover, the rapid increase in cross-border capital flows among nations has allowed serious debt and exchange-rate imbalances to grow unchecked. In addition, the changing role of financial institutions and the development of new financial instruments and practices are affecting the ways in which economic activities are financed. While these changes create opportunities for Canadian investors, Canada is also at risk as national financial markets become increasingly interdependent.

In order to attain a clearer picture of how developments in this area affect Canada, the Council launched a new project on international finance last April. To find out more about it, *Au Courant* spoke with project director André Ryba.

Au Courant: Where does Canada stand in terms of its competitiveness in international financial markets?

Ryba: Canada has always had world-class financial institutions. We have some very strong banks, life insurance companies, and emerging financial holding companies. Canadian banks are leaders in providing syndicated loans (where two or more banks join forces to finance a major project). But international financial markets are evolving rapidly. We are seeing a shift away



André Ryba

from traditional banking to securities trading. For example, instead of taking out a loan, a borrower issues bonds or notes to raise capital, using a bank as a broker to sell, and possibly to underwrite, a certain portion of them. Another form of "securitizat on" that has grown rapidly is the bundling of loans into securities pools, units of which are sold to investors. It appears, however, that this innovative process has not spread as quickly among Canadian banks as it has among U.S. institutions. Part of our study will look at why Canadian firms are less innovative in the financial area – is it because of regulation or taxation, for instance?

Au Courant: At the international level, what other changes are taking place that affect Canada?

Ryba: Perhaps the most significant development occurring at the moment is what we call the "globalization" of financial markets. What this means, taking the U.S. government bond market as an example, is that despite the existence of separate bond markets in New York, Tokyo, and London, in reality these are part of a single worldwide market. Indeed, many investment dealers operate in all three markets, passing their trading operations from London to New York to Tokyo and then back again as one market closes and another opens. We may even see the end of the traditional exchange floor, since computers can replace it on a 24-hour basis. The globalization of financial markets raises some very serious policy implications for Canada. For example, are we going to see Toronto downgraded to a regional securities market? Will it be more difficult to finance industry as a result? Moreover, as markets become more and more interdependent, it becomes increasingly difficult to conduct independent macroeconomic policy.

Au Courant: How can we conduct effective domestic policy in view of the world's growing economic interdependence?

Ryba: Basically, there are two issues that arise in this regard. The first is whether or not we view Canada as a catalyst in bringing countries together to solve mutual problems and to coordinate national policies for mutual benefit. Clearly, the growing interdependence of national economies underlines the need for some form of international cooperation. The U.S. balance-of-payments deficit has to be resolved one way or another, for instance. Discussions among central bankers, finance ministers, and supervisors of financial institutions are already under way, with the objective of achieving greater coordination in financial activities. There are many opportunities for Canada to make a contribution. I think we can play an important role in the discussions on trade in financial services under the framework of the General Agreement on Tariffs and Trade, for example. The second issue that we have to consider is what policy options are available to enable Canada to gain from new opportunities and to shield itself as much as possible from the negative effects of world events. In this sense it's important to understand the factors that have contributed to recent developments on international financial markets. This

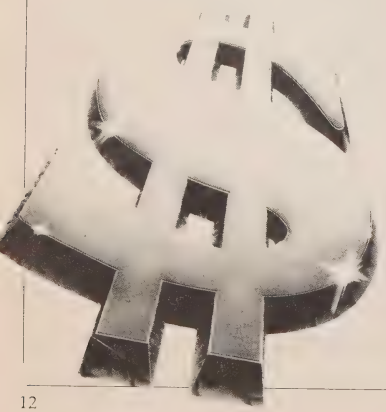
will give us some sense of what Canada's approach should be in world forums, and some idea of what types of domestic policy would promote our best interests.

Au Courant: What will the project be looking at specifically?

Ryba: It will be broken down into four areas of study. First, we shall be looking at recent developments on international financial markets, such as changes in capital flows; balance-of-payment positions; financial innovation; the growth of international financing; and the emergence of London, Tokyo, and New York as international financial centres. Different scenarios will be developed with respect to the future pace of globalization. Second, we shall examine trade in financial services, including barriers to trade and the consequences for Canada of moving to freer trade in this area. Third, we shall look at the fragility, or stability, of the international financial system by examining the impact of recent developments such as the increase in cross-border capital flows. Finally, we shall study how all of these developments affect Canada. Will these changes give Canadians better access to investment opportunities abroad? How will the Canadian financial industry fare in the future? Are Canadians going to be better served? What policies are needed to ensure that Canada will be able to take advantage of new opportunities?

Au Courant: How will freer trade in financial services affect Canada?

Ryba: First, we have to agree on what we mean by freer trade. There is already free movement of capital between countries. So in that sense free trade already exists. In Canada, however, the right of establishment (to set up a subsidiary of a foreign bank, for instance) is regulated by government. If freer trade means opening up our borders to foreigners, then we may see a greater number of financial failures because of the increased competition. But competition is healthy, as long as we maintain a proper balance between competition and solvency. Moreover, foreign firms are likely to bring with them innovative instruments. Another likely benefit of opening our borders to foreign competition is that Canadian firms will have access to new foreign markets. In fact, the entry of foreign financial firms into Canada should be based on reciprocity, so that Canadian firms will have equal access to the foreign markets concerned. The Council made this recommendation in its recent Statement on financial institutions (*Competition and Solvency: A Framework for Financial Regulation*; see *Au Courant*, vol. 7, no. 3).



Au Courant: Is too much government regulation making our financial sector less competitive than that of other countries?

Ryba: A lack of regulation doesn't necessarily enable you to be more competitive. Financial activity moves away from overregulated countries, but it does not move to places where there is no regulation. You need some rules of the game to have confidence in the institution and in the financial system. You cannot operate in a jungle as far as finance is concerned. What is important is to have the proper dose of regulation – the minimum amount required to ensure stability and confidence. At the same time, you must remember that we do not regulate the activities of Canadian institutions outside Canada. In fact, they are involved in activities abroad that they are prevented from engaging in domestically. If, however, we have too strict a regulatory framework in Canada, many of our institutions will operate out of London instead of Toronto, for example. The recent accord between the Ontario and federal governments, which allows banks and life insurance companies to operate securities subsidiaries, is a step in the right direction.

There is a real fear that Toronto's position will deteriorate rapidly unless we match the regulatory climate of the London and New York markets.

Au Courant: But aren't Canadian firms taking more and more of their business to London, where there is less regulation?

Ryba: Yes, this was true in the past – not only for banks but for investment dealers as well. There is a real fear that Toronto's position as a major financial centre will deteriorate rapidly unless we match the regulatory climate of the London and New York markets, although London is increasing the regulation of international markets. In Europe, a number of major financial centres lost out to London as a result of the regulatory reform in that city. Now Paris is trying to gain back lost business by reregulating also. But it may be too late; London may have taken an insurmountable lead.

Au Courant: How soon do we have to act to prevent a similar decline in Toronto?

Ryba: Yesterday was already late. We have to act very soon. Actually, one of the issues we'll be considering in this project is what can be done to maintain the strength of Toronto, since London and New York have already taken a huge lead.

New members appointed to the Economic Council



Jacques Bougie is president of Alcan Extrusions. A graduate of the Université de Montréal and the École des hautes études commerciales, he is also a member of the Quebec bar. He has served as a school board administrator and as director general of the Société québécoise d'information juridique.



Alix Granger is vice-president of Pemberton, Houston, Willoughby, Inc. A graduate of the University of Toronto and Simon Fraser University, she has written numerous articles and publications on financial matters, and frequently appears as a guest commentator on radio and television.



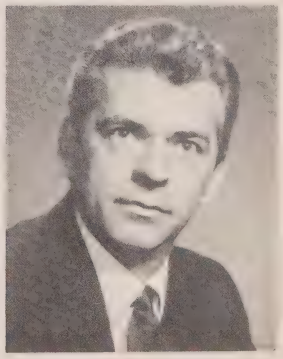
William Mackness is senior vice-president and chief economist of the Bank of Nova Scotia. He is also a member of the board of trustees of the Fraser Institute and a past member of the Ontario Economic Council, and he has served as a special policy advisor to the Minister of Finance. He is a graduate of the Université de Montréal and the University of Western Ontario.



Bartlett B. Rombough is president and chief executive officer of PanCanadian Petroleum Ltd. He serves on the board of governors of the Canadian Petroleum Association and is chairman of its natural gas committee. He is also a member of the Institute of Chartered Accountants of Alberta and Manitoba.



Ken Stickland is president of both KenAgra Management Services Ltd. and Cen Alta Grain, as well as a director of Stickland Farms. He is a member of the Canadian Association of Agricultural Economists and the Agricultural Institute of Canada. He has served as a special advisor on agricultural transportation to the Alberta government and as an officer of the Alberta Export Agency. He is a graduate of the University of Alberta.



Norman E. Wale is general manager, planning, of Canadian Pacific Ltd. He was formerly a research director at the Economic Council and has taught economics at the Université de Montréal, of which he is a graduate. He has also served as director general of the university branch at the Ministry of State for Science and Technology.

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Economic Council of Canada

Volume 8, No. 3, 1988

The ECC odyssey



- Appraising CANDU
- New project on social policy
- The changing role of Petro-Canada

PUBLICATIONS

New Council report

The Taxation of Savings and Investment (EC22-143/1987E; $10.95 in Canada, $13.15 elsewhere).

This research report provides detailed analytical findings to support the Council's Statement on Taxation. It analyses the major taxes on incomes, property, and resources, and examines possible changes that would make the system more efficient in those areas.

Research studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request. Each study clearly attributes the findings and conclusions therein to the individual author or authors rather than to the Council. Three new titles have been published (ordering information below).

Workplace Innovation in Canada: Reflections on the Past . . . Prospects for the Future, by *Jacquie Mansell* (EC22-146/1987E; $4.95 in Canada, $5.95 elsewhere).

Atomic Energy of Canada Limited: The Crown Corporation as Strategist in an Entrepreneurial, Global-Scale Industry, by *George Lermer* (EC22-145/1987E; $8.95 in Canada, $10.75 elsewhere).

Petro-Canada: Its Role, Control and Operations, by *Paul Halpern, André Plourde,* and *Leonard Waverman* (EC22-147/1987E; $9.95 in Canada, $11.95 elsewhere).

Technical papers

Technical papers deal with subjects of interest to specialists and contribute new information or original analysis to their particular fields of research. Each paper clearly attributes the findings and conclusions therein to the individual author or authors rather than to the Council. One new title has been published (ordering information below).

Taxation and Savings in Canada, by *Charles M. Beach, Robin W. Boadway*, and *Neil Bruce* (EC22-144/1987E; $10.95 in Canada; $13.15 elsewhere).

Discussion papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in specific or related fields of research. The papers are reproduced only in the language in which they are written. Each paper is the personal responsibility of the author or authors, and distribution by the Council does not imply that the conclusions of the paper have been endorsed by the Council.

No. 329 "The origins of government enterprise in Canada," by *John Knubley*.

No. 330 "Something ventured – The Canada Development Corporation, 1972-85," by *Abraham Tarasofsky*.

No. 331 "Impact of Canada-U.S. free trade on the Canadian economy," by *S. Magun, S. Rao*, and *B. Lodh*.

No. 332 "Taux marginaux d'impôt effectifs du secteur de l'habitation au Canada," by *Pierre Mercier*.

No. 333 "Depository institutions: Risks and insolvencies," by *H. H. Binhammer*.

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion papers, *Au Courant* and the *Annual Report* are available without charge from the Publications Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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Volume 8, No. 3, 1988

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Conference on agriculture

A conference on the "Future of Prairie Agriculture" will be held at the Saskatoon Inn on March 21-22, 1988. Sponsored by the Department of Agricultural Economics at the University of Saskatchewan and supported by the Economic Council of Canada, the conference will focus in large measure on the Council's research project examining the future of Prairie agriculture. The project is being undertaken at the request of the Prime Minister of Canada and the Premier of Saskatchewan.

For further information and details on registration, contact Glen Hass at (306) 966-5551.

Au Courant *est également disponible en français.*

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its staff and others. The findings of these reports are the personal responsibility of the authors. Neither the original publication of these studies and papers, nor their condensation for the purposes of this magazine, should be taken to imply endorsement of their conclusions and recommendations by the members of the Economic Council.

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Into the future

Every organization needs a road map – a vision of where it is going and at least a rough idea of how to get from here to there. The Economic Council is celebrating its 25th anniversary in 1988 by setting out a road map showing where it is headed for the 1990s. And that road map calls on the Council to help Canadians make better choices with regard to where the country is heading.

I believe that information matters. By being a creative source of new ideas for use by policy makers, the Economic Council can make a meaningful contribution to the well-being of Canada and Canadians. By helping people to understand policy problems and policy options, we can help them to make better choices as voters, consumers, investors, and taxpayers.

The Council is federal in its funding but national in its focus. We address our advice to federal and provincial governments, and, at times, to the private sector. Our long-term orientation enables us to spot trends, to identify emerging issues, and to study them in a comprehensive way.

Sound analysis

The Council's recommendations are forged from in-depth research by a team of experts in combination with consensus debate among Council members from every region and every economic sector. The research ensures that Council advice is rooted in accurate information and based on sound analysis, while the consensus debate tests such analysis against all the constraints and sensitivities of the real world. No other research organization in Canada offers that unique combination.

In their attempts to reach agreement –





Chairman Judith Maxwell reflects on the future of the Economic Council as it enters its 25th year of existence.

and even when they cannot all agree – members of the Council mirror the debates and discussions of all Canadians. By applying their practical knowledge of Canadian issues to research by our top economists and by experts in other fields, Council members serve as pathfinders for Canadians on some of the most important and contentious issues of our day.

In an era of tough decisions, polarized debate, and high-pressure public relations, the Council owes Canadians a steady flow of research and analysis that will provide objective and accurate information, clearly stated in English and French, on subjects that matter.

Changing needs

The Council was created in 1963, at a time when there were no private economic research organizations and few policy units in government. Lester Pearson, the Prime Minister at that time, and John Deutsch, the Council's first Chairman, saw the need for a research unit, at arm's length from government, that would employ the best and the brightest, and focus on a longer-term horizon. Over the years, the needs changed, as effective private research groups came on the scene and as government departments strengthened their research capacities.

Since I joined the Council as Chairman in November 1985, we have done a considerable amount of soul-searching about the best course to set for the Council in the 1990s. We keep advising Canadians that they must accept change and adapt to new circumstances. This is just as true for the Council as it is for any other organization; hence it has developed a strategy for the years ahead.

New directions

First of all, we recognize the volatile, fragmented, and complex political environment in which economic ideas must be judged. If the Council is to continue to play an active and useful role in informing Canadians on key economic issues, we have decided that we must speed up, diversify, and turn outwards.

Speeding up means organizing our projects so that they will produce useful results within 18 months or less.

Diversifying means attacking many subjects at one time. It also means going beyond economics, using the insights offered by political science, geography, sociology, and even the hard sciences to help solve policy problems.

Turning outwards means that we must pay much more attention to our audiences – both the policy makers and individual Canadians. We must write or speak clearly, in French and English, and find new ways to deliver our messages – through shorter, more-readable reports, for example, and more-frequent seminars, round-table discussions, and conferences.

Canada needs a think tank that can see beyond this year's melee of issues, understand the longer-range consequences of the choices being made this year, and then explain those consequences in a clear, confident voice. It is therefore critical that the Council become much more inventive in the way it defines its agenda.

The future is shaped, to a very considerable degree, by the cumulative efforts of the policy choices that we make. The Council must have the vision, the intellect, and the courage to give Canadians the information they need to make wise decisions. That is the challenge of the Council's next 25 years.

The first quarter-century



It was on August 2, 1963, that Parliament unanimously passed the Act that formally ushered the Economic Council into being.

Almost a quarter of a century and seven chairmen later, the Council has earned a reputation for excellence in fulfilling its mandate to "advise and recommend" how best Canada can achieve such goals as "a high and consistent rate of economic growth" and "rising living standards (for all Canadians)."

The years preceding the founding of the Council were fraught with uncertainty and concern about slow economic growth. The late 1950s and early 1960s saw a virtual cessation of increases in the real living standards of most Canadians, high rates of unemployment, under-utilization of the country's productive capacity, and some slippage in the country's productivity and competitiveness in relation to other countries. It was clear to many that continuing to react to these problems in an ad hoc, short-term fashion would lead to a continuation, or even an intensification, of the country's economic woes. Hence much of the discussion that led to the creation of the Council centred on the need for medium-range study and economic analysis.

The early years

From the beginning, the Council was intended to be an independent, non-partisan research body that would study medium-term economic issues and that would issue recommendations based on a consensus of Council members. As it stands today, the Council consists of a board appointed by the Prime Minister, comprising three full-time and up to 25 part-time members. The full-time members – the Chairman and two Directors – manage the work of a staff of economists and other specialists. The part-time members, who represent various sectors of Canadian society and regions of the country, help in selecting research topics, reviewing research results, and developing policy advice for governments and the public. As well, they serve on advisory committees for Council research projects, together with outside experts in the particular field under study. This involvement gives pragmatic guidance to the research and facilitates the development of consensus among Council members in fashioning policy advice and recommendations. The Council has five main policy goals: the encouragement of full employment; a high rate of economic growth; reasonable stability of prices; a viable balance of payments; and an equitable distribution of rising incomes among individuals and regions.

Breaking ground

Under the guidance of John Deutsch, the Council's first Chairman (1963-67), much of the early research work at the Council broke new ground. Council researchers were the first in Canada, for example, to experiment with potential output analysis techniques that had only begun to be used by academics in the United States. By comparing actual output with potential output, economists could arrive at some idea of the effectiveness of a country's economic policies. Other ground-breaking work pioneered by the Council at that time included an examination of the relationship between education and productivity. In 1966, the Council received the first of many government references (contract research requested by the Prime Minister). That first reference dealt with the relationship of prices, costs, productivity, and incomes to sustained economic growth. It, together with another reference that looked at consumer affairs, competition policy, and intellectual property, had a major impact on the structure of government. Among other things, for example, these references highlighted the need to rationalize government programs in such areas as manpower and employment, regional expansion, and consumer and corporate affairs.

At least two important events stand out during the chairmanship of Arthur Smith (1967-71): the Council began developing the original version of its CANDIDE econometric model of the Canadian economy; and the Council confirmed its independent stance. In regard to the latter, many Council documents reflected this independent turn of mind by taking positions critical of the government. In the Council's view, for instance, the government at that time should have been using its stabilization policies less frequently and with an eye to increasing medium-term or long-term potential growth.

Research excellence

Council Chairman André Raynauld (1971-76) brought about a change in emphasis from the policy orientation that had characterized the previous two administrations to an accentuation of researchers' technical skills. In this regard, the Council scored a major success with the completion of its CANDIDE econometric model. It was now possible to show in detailed quantitative terms the consequences of the Council's policy recommendations. This was particularly important, since the Council's five main policy goals were thought by some to be mutually exclusive. (It can be argued, for example, that efforts to fight inflation can cause unemployment. CANDIDE enabled economists to see the effects of policy prescriptions on all of the Council's policy goals.) CANDIDE was an innovation in Canadian economics. The two other models that existed at the time were specialized and were designed to model special problems. CANDIDE, however, was a multipurpose model designed to fulfil many goals at the same time.

Raynauld also placed greater emphasis on consultation. Under his stewardship, the Council organized two national economic conferences that brought together leaders in all sectors of the Canadian economy and society to discuss major issues affecting the economy. Unfortunately – and ironically – it was at that time that labour representatives on the Council walked out over the government's wage and price controls. The walkout was part of a general withdrawal of trade union representatives from many government bodies.

Internally, Raynauld reorganized the Council by introducing project teams, each with a specific mandate. The restructuring resulted in improved productivity and project control, and better use of the Chairman's time.

As a footnote to that period, it is worth noting that the Council recommended free trade with the United States. At that time the suggestion received a chilly reception in the business community.

George Post (1976-77) served as the Council's Vice-Chairman and Director prior to being appointed Acting Chairman for a year and a half. Under his guidance, the Council issued several influential reports. Its project on financial markets led to the publication of, among other reports, *Efficiency and Regulation: A Study of Deposit Institutions*. The study called for greater competition in Canadian financial markets, and many of the recommendations in it were reflected in the 1980 revision of the *Bank Act*. In 1977, the Council published *Living Together: A Study of Regional Disparities*, which has been reprinted four times over the past decade.



Higher profile

Sylvia Ostry was appointed Chairman in 1977. In her two years with the Council she was successful in raising its profile by increasing support for the Council's work. During her tenure, for example, the Council received three references from the Prime Minister. Only three had been given prior to that.

In 1980, David Slater, then a Director at the Council, was appointed Chairman. With his appointment, the Council once again took on a more technical orientation. Meanwhile, the Canadian economy was being hit by a number of serious shocks. High unemployment, high interest rates, high inflation, and the collapse of the western Canadian energy-based economy were among the country's economic woes. The ferocity of these problems led to more and more demands on the Council to concern itself less with the longer term and more with short-term solutions to these critical problems. The Council undertook a number of projects in such areas as energy; women and the economy; productivity; taxation; and a special report on the western Canadian economy.

Increasingly, the Council's work incorporates research techniques from such disciplines as sociology, political science, even the hard sciences.

Diversification

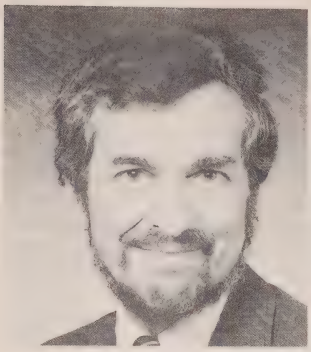
The appointment of Judith Maxwell as Chairman in 1985 marked the beginning of the present period of the Council's history. Over the past two years the Council has undergone a number of changes. In its research work, there is a more pragmatic policy orientation, faster throughput of work, and a greater diversity of projects under way at one time. The output of the Council has increased dramatically as well. Whereas in earlier years it produced an Annual Review of the economy, along with several other reports, last year the Council published the Annual Review, two Statements, and two research reports, in addition to the regular flow of research studies and discussion papers. It is also putting more weight on communicating its research through speeches, seminars, conferences, media relations, and frequent appearances before parliamentary committees.

In part, these changes reflect the changing environment in which the Council operates. Increasingly, for example, economists are incorporating into their work techniques from such disciplines as sociology and political science. The Council is broadening its focus accordingly, employing experts in fields other than economics. As it responds to continuing changes in the environment, it is certain that the challenges facing the Council over the next 25 years will be as exciting as those which were part of its first quarter-century.

New director discusses Council

Last summer, Harvey Lazar was appointed as one of the Council's two full-time directors. A graduate of McGill University, the University of British Columbia, and the London School of Economics, he has had extensive experience in government at both the federal and provincial levels. Most recently, he was Administrator of the Petroleum Incentives Administration at Energy, Mines and Resources Canada. Before that, he was Executive Director of the Petroleum Monitoring Agency and had worked in a number of capacities for the federal Department of Finance, including that of Director of the Task Force on Retirement Income Policy. He also served as an associate deputy minister for the British Columbia government.

In the following interview with *Au Courant*, Lazar discusses some of his views of the Council.



Harvey Lazar

Au Courant: In what direction do you see the Council moving in the future?

Lazar: It seems to me that we are moving increasingly into a period in which economic issues will overlap environmental, technological, social, and political matters. While this has been true in the past, it is my sense that the overlaps will become even greater in the future. Therefore the Council will probably have to become increasingly interdisciplinary in its approach to economic matters and to public-policy analysis generally. It will become more and more difficult for us to look at issues from a purely economic perspective. I might add, however, that the discipline of economics is sometimes very useful in examining the non-economic aspects of public policy. By that I mean that we can use economics as an analytical tool for examining environmental matters, social concerns, and so forth.

Au Courant: Critics say that the Council is just one of many research organizations in Canada today that offer policy advice. What expertise does the Council have to offer that the other bodies do not have?

Lazar: I'm not sure I see it principally as a question of expertise. Rather, I see the Council as a unique organization in that its structure encourages a consensus approach to the formulation of economic policy. The Council staff's economic analysis is blended with the practical knowledge of a Council membership that is representative of the major segments of Canadian society, including both the regional dimension and various occupational groupings. So the Council combines – in a unique way, I believe – a strong economics capability with a consultation mechanism that ought to result in its advice being highly relevant to decision makers.

Au Courant: What major economic issues should the Council be addressing over the next few years?

Lazar: First, the events in the stock market (in October 1987) suggest that we are going to have to revisit the world of macroeconomic policy. In recent years, macroeconomics has fallen into disrepute in the eyes of many people. But the failure of the world's major economies to get their fiscal and trade figures into balance is quite clearly a tremendous source of disequilibrium in the world economy. So I believe that governments are going to have to return to the principal lessons that macroeconomics can teach and to take them far more seriously than they have over the last decade. Second, and a related point, there is the growing integration of the world economy and what this implies in terms of international trade and capital flows, and movements of technology and know-how. The Council will have to continue to place heavy emphasis on these issues. In this regard, we are indeed continuing our work in the area of international trade, and we also have under way a major project on international finance. Third, there will be an increasing need to be concerned with people – or "human capital" if you prefer jargon. This will require us to sustain our efforts in the areas of employment, labour markets, and diffusion of technology, and it will probably result in a growing interest in education and training. In addition, there are numerous specific industries and regions of the country that are cause for continuing concern. Some of these are now being studied by the Council. Prairie agriculture and regional development are examples of two projects now under way. In fact, I think the Council has done a good job in recent years in identifying where the challenges lie. Finally, we're just beginning a project entitled "Visions of the Nineties." This will entail looking ahead and anticipating in a systematic way the kinds of concerns that are likely to be on the public agenda in the mid-1990s and beyond.

Au Courant: From a personal point of view, what do you hope to contribute to the Council?

Lazar: I bring to the Council considerable experience in how governments operate and how economic and social policy is made. For some years I have been involved in a broad range of areas – from international economics to social policy, from international negotiation to federal-provincial relations. I hope that this institutional knowledge and practical experience in government, when blended with the professional capabilities of the Council staff, can help it in the formulation of constructive policy proposals for governments. More generally, I would hope that I could help to build bridges between the Council and the major decision-making organizations at the federal and provincial levels. My past work has given me an opportunity to get to know very well many of the key people at both levels. I believe that this will assist the Council in understanding better the needs of government and, at the same time, assist governments in understanding how the Council can contribute to their decision-making process.

An assessment of CANDU

Atomic Energy of Canada Limited has failed to make its CANDU nuclear reactor a commercial success because it is at a disadvantage in being a Crown corporation, according to new Council research.

The federal government established Atomic Energy of Canada Limited (AECL) in the early 1950s to develop the Canada Deuterium and Uranium (CANDU) nuclear reactor system. When the CANDU was first considered for commercialization, it was thought that it could be profitably exploited for the Canadian market alone. But its commercial success depended upon breaking into highly competitive world markets, where government enterprises are "at a disadvantage," says George Lermer of the University of Lethbridge, in a study done for the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3).

Lermer explains that the government restricts the options available to the managers of public firms because it retains control over financing; hence these managers are unable to implement long-term market strategies. But in highly competitive world markets, firms that do not have a viable long-term strategy are "unlikely to be in the industry when the 'shake-out' is complete," Lermer says.

In the nuclear reactor business, companies such as Westinghouse and General Electric have been movers and shakers from the outset. Westinghouse, for example, provided nuclear power stations on a fixed-price, "turnkey" basis (ready to operate); it guaranteed the price of uranium under long-term sales contracts; and it licensed its technology and entered joint ventures in France, Japan, and elsewhere.

Entrepreneurship lacking

Canada, on the other hand, displayed no such capacity for marketing entrepreneurship, Lermer says. AECL focused its marketing efforts on Ontario, where its major buyer was Ontario Hydro. That was a natural step for a mission-oriented firm whose task was to develop the CANDU system for Canada. But a private company, with the knowledge that long-run survival is unlikely if based solely on the domestic market, would have acted differently, Lermer argues. When AECL later realized that it would lose credibility at home and abroad if it failed to market its reactors outside Canada, it concentrated on selling to Third World countries at concessionary prices. All such sales, in fact, have been made at subsidized export financing rates.

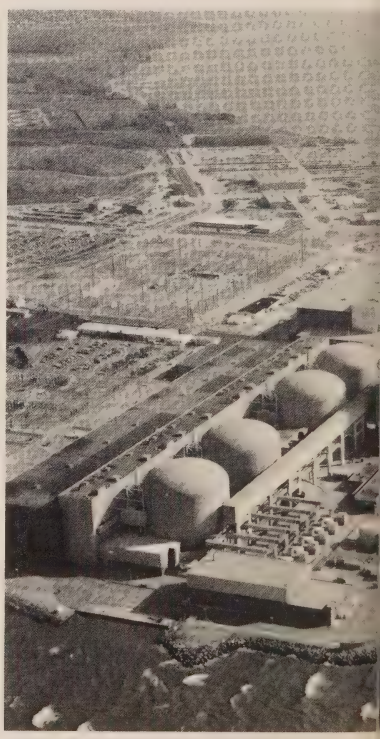
Because AECL was convinced that industrial countries would protect their home markets, it stayed out of the U.S. and German markets. However reasonable that assumption may have seemed, "AECL can be faulted for not having tested those limits," Lermer says. There were opportunities to sell to privately owned utilities, he insists. AECL, possibly along with Canadian General Electric, could have made an effort to sell reactors in the U.S. market during the 1965-74 boom in reactor sales, for example. The fact that U.S. reactor manufacturers had stopped offering turnkey projects in 1967 provided a door through which AECL could have entered the U.S. market. A turnkey sale to a U.S. utility "would have made a real impression abroad during that critical time when operating experience was unavailable for any of the competing types of reactors," Lermer explains.

Instead, AECL became dependent upon a single market that unexpectedly evaporated in the 1970s. (At the moment, there is thought to be some potential in Quebec and the off chance that AECL may place a reactor or two in British Columbia and another one in the Maritimes.) Today, with German, French, and U.S. producers of light-water reactors so firmly entrenched in international markets, the odds are now against any revival of CANDU, Lermer maintains.

Marketing failures

The most damaging marketing failure of AECL was its cavalier attitude to heavy-water development and pricing. Though fears about the availability and cost of heavy water to supply CANDU reactors was the Achilles heel of the CANDU program, "no dramatic steps seem ever to have been taken to dispel customer concerns," Lermer discloses. The U.K. rejection of the CANDU in the early 1970s is alleged to have been due to the cost of heavy water and the risk of producing it in highly populated areas. In the mid-1960s, when customers were worried that the CANDU might leak heavy water, AECL should have guaranteed supplies at its own expense, Lermer suggests. Later, when AECL was able to establish that CANDU is leakproof, it should have guaranteed firm concessionary prices for heavy water.

The second major factor that hindered CANDU's success was the three-year delay during the boom period in reactor sales in bringing into operation the Douglas Point reactor, which was Canada's demonstration stage reactor. Here, the weaknesses in allowing a research or mission-oriented organization to dominate



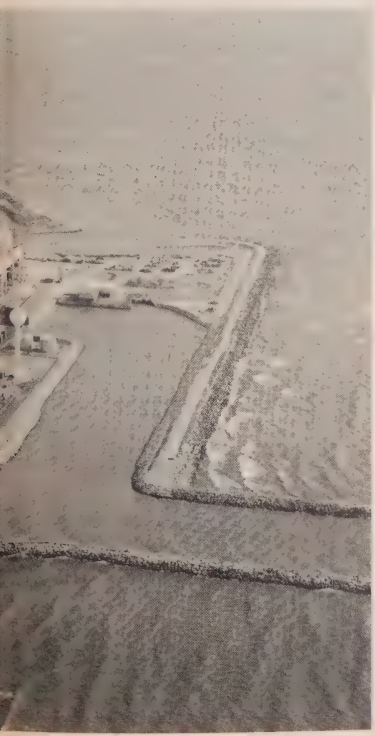
AECL's CANDU reactor at Pickering, Ont.

commercial enterprise seems to have come into play, Lermer says. For instance, one of the sources of delay was AECL's decision to change the design of a fueling machine during the construction stage of the project. "Had the Douglas Point reactor operated successfully in 1964 and had heavy water become available at reasonable cost, it is likely that CANDU could have become a major player in world markets," Lermer believes.

Another marketing weakness that remains today is that AECL is one of the few vendors of nuclear reactors that is not also integrated into manufacturing the basic components of its system. This situation developed primarily because Ontario Hydro was the only utility willing to co-finance reactor development. It agreed to take on the risks of developing CANDU, in partnership with AECL and the provincial government. It took on responsibility for the manufacture and construction of nuclear power stations, leaving AECL as the designer only.

Costs and benefits

Because the demand for electricity, and thus for nuclear reactors, has fallen far below pre-1975 estimates, the CANDU has been expensive for Canada. In Lermer's estimate, the federal government has spent the equivalent of $18 billion (in 1981 dollars) on the CANDU program. Ontario Hydro is estimated to have saved $1 billion in choosing nuclear power over coal-fired generating stations. In Lermer's view, the high hopes held for the CANDU program "have failed to materialize." The best that can be said for the economics of the program is that it did stimulate research and development in Canada, and it enabled Canadians to participate in nuclear-engineering research without leaving home, he says.



A.E.C.L.

Future demand

Since 1978, AECL has taken stock of the need to restructure itself in light of reduced government support for research and development, and of few, if any, new orders for CANDU reactors. But no clear-cut strategy has been settled upon. Rather, the company has appeared to plod on in the expectation that the odd reactor order will be forthcoming over the next decade and that the market will rebound in the late 1990s. As for the industry's future prospects, the U.S. market remains the most promising for Canada; an enormous aging, and expensive, stock of generating capacity will be replaced there over the next few decades. But the CANDU faces an uphill climb in the United States because of the abundance of coal and the surplus manufacturing capacity in the industry. (It is by no means clear that nuclear power has any cost advantage over coal, even in Ontario, Lermer points out.) Canadian orders for the CANDU will only follow if domestic utilities sell surplus power to U.S. utilities, which, according to Lermer, is more a hope than a prospect.

Moreover, unless AECL sustains research and development at some reasonable minimum level, it is conceivable that even Ontario Hydro will turn to foreign producers and designs for the next generation of Canadian reactors, the author warns. Unless AECL aims at selling in world markets as well, it would be "foolhardy" to expend large sums of money to improve the CANDU, he adds. Without such expenditures, however, the CANDU is unlikely to even hold on to the domestic market.

> *If Canada's nuclear industry does not receive a major financial infusion, it is unlikely to survive.*

Lermer sees AECL's choices as limited. Either it develops a marketing strategy that offers some hope of expanding the market for the CANDU or it forms some sort of alliance with a foreign reactor developer. The first alternative would require an investment of about $6 billion over the next 10 years, and AECL would have to develop credibility in world markets, preferably by selling in the U.S. market. But Lermer has "serious reservations" as to whether a Crown corporation is the proper instrument for so large and risky a public investment. The second strategy would entail seeking partners, whether for CANDU or someone else's technology. It would likely be less costly than the first option, but it could be difficult to find a partner.

Possible merger

If Canada's nuclear industry does not receive a major financial infusion to carry it into the next century, it is unlikely to survive, Lermer concludes. At the same time, there is no certainty that the market for nuclear power will revive. Lermer suggests that if the CANDU program is to be allowed to wither, consideration should be given to a merger of all or part of AECL with Ontario Hydro. Alternatively, if the government chooses to invest heavily in a new effort to prepare for the next round of reactor orders, then some form of privatization of all or part of AECL should be seriously considered. Lermer cautions, however, that his study does not provide a sufficient basis for deciding on either AECL's or CANDU's future. Rather, his analysis reveals that greater consideration should be given to channeling government support for commercializing new technologies to private enterprises.

Atomic Energy of Canada Limited: The Crown Corporation as Strategist in an Entrepreneurial, Global-Scale Industry, by George Lermer (EC22-145/1987E; $8.95 in Canada, $10.75 elsewhere).

The evolution of Petro-Canada

Petro-Canada's 1984 mandate to operate basically as a commercial enterprise suggests that there are few reasons to maintain it as a Crown corporation, a new Council study says.

The study contends that, in general, Crown corporations without a valid social purpose should not be maintained, because of the costs and difficulties in effectively monitoring and controlling them. But the study cautions against making a hasty decision to privatize Petro-Canada. The federal government should first examine the long-term potential of the oil and gas sector, the nature and extent of public-policy objectives in that sector, and the range of policy instruments available to achieve those goals. Should such an analysis find little scope for a social role to be attributed to a national petroleum corporation – or that a Crown corporation is not the most effective tool – "then we would recommend the privatization of all of Petro-Canada's equity," conclude professors Paul Halpern, André Plourde, and Leonard Waverman of the University of Toronto.

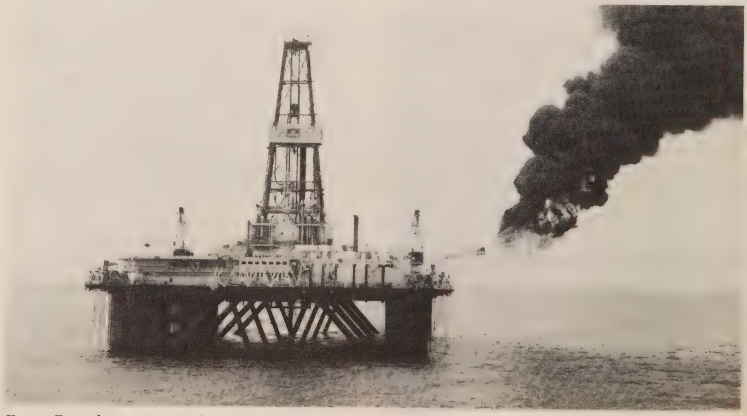
Their study traces the emergence and development of Petro-Canada, and it suggests ways to assess the company's performance and to control its activities more effectively. Their suggestions apply generally to the monitoring, control, and evaluation of all Crown corporations. The research was carried out as part of the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3).

The early years

At its inception in 1976, Petro-Canada's mandate included a number of social objectives. Principally, it was established to increase Canadian supplies of oil and gas, mainly by exploring and developing the country's geological and technological frontiers; it was to be a vehicle that would enable the federal government to increase its knowledge of the oil and gas sector (the "window-on-the-industry" function) and subsequently assist it in designing policies for that sector; and it was established to increase Canadian participation in the domestic oil and gas industry. The authors explain that several developments spurred the creation of Petro-Canada, including concern over foreign ownership of the oil and gas sector, and problems in the international petroleum market in the early 1970s. Overall, the government perceived Petro-Canada's role to be that of increasing the industry's capacity to discover and produce the country's oil and gas resources.

The authors note that during its first few years of operation Petro-Canada did not depart appreciably from the scope of activities defined as appropriate either by the federal government or under the firm's original mandate. Many of Petro-Canada's activities related to the exploration and development of oil and gas reserves on Canada's geographical and technological frontiers, including joint-venture projects with private companies. But in 1978 it became embroiled in a battle for control of Husky Oil Ltd., whose assets included oil refineries and retail product outlets in the United States as well as Canada. At the time, the government agreed with Petro-Canada that the acquisition was the only way to bring about the development in the near future of Husky's heavy oil deposits in Lloydminster, Saskatchewan. But neither the government nor Petro-Canada made any statement about what would happen to Husky's U.S.-based assets or its downstream activities should the take-over occur.

The bid for Husky failed, but soon thereafter Petro-Canada acquired a controlling interest in Pacific Petroleums Ltd. The federal government defended the acquisition as a commercial transaction that would provide Petro-Canada with the cash flow from production needed to finance some of its frontier exploration and development projects. This would reduce Petro-Canada's reliance on the public purse, the government argued. But the acquisition also meant that Petro-Canada would now actively compete with existing companies in the refining and retailing business. In the ensuing political debate over Petro-Canada's entry into these downstream activities, proponents of the move noted that the company's retail outlets had become very popular with the Canadian public. They also argued that the outlets provided a concrete example of increased Canadian ownership of the industry. Whether or not the Crown firm initiated the transaction in order to acquire downstream assets cannot readily be determined from the available evidence, the authors concede. But Petro-Canada did manage to hold on to its refining and marketing assets even during the period when its sole shareholder (the minority Conservative government in 1979) seemed intent on returning to the private sector at least some of those assets which served no public-policy purpose.



Petro-Canada

Petro-Canada was created mainly for exploration and development.

Canadian ownership

The introduction of the federal government's National Energy Program (NEP) in 1980 expanded the role of Petro-Canada. It signaled an increase in the interventionist nature of Petro-Canada's mandate by suggesting that Petro-Canada would be a key vehicle in the pursuit of increased Canadian ownership and control of the oil and gas sector. The Crown firm subsequently purchased Petrofina Canada Ltd., the downstream assets of BP Canada Ltd., and later the western Canadian downstream assets of Gulf Canada, making it one of the country's larger retailers of oil products. At the same time, Petro-Canada's continued role as a source of information and advice to the government on matters relating to energy policy (including the NEP) placed the Crown firm's officials in a potential conflict-of-interest situation, the authors maintain. "We do not suggest that any impropriety has taken place," they counter. Nonetheless, Petro-Canada did benefit from many of the provisions under the NEP.

Prior to 1982, Petro-Canada's record shows strong support for projects at the frontier of oil and gas technology, consistent with the Crown firm's original mandate. But in subsequent years Petro-Canada refocused its activities "to emphasize a better balance between short-term cash-generating activities and higher-risk, longer-term projects," according to the company's 1983 annual report. In fact, the firm announced no high-risk, long-lead-time projects in 1983 (nor were any proposed in 1985 and 1986). "This heightened concern about 'bottom-line' performance meant that Petro-Canada was moving closer to operating like any private-sector oil and gas firm," the authors maintain.

New mandate

In 1984, when it was given a new mandate to operate in a fundamentally commercial manner, Petro-Canada nonetheless retained its "window-on-the-industry" function. Since it was now supposed to operate even more like a representative industry player, the potential for conflicts of interest in providing information to the government would appear to have increased, the authors warn. Moreover, the new mandate requires that a written directive be issued should the government decide for Petro-Canada to undertake an activity deemed to be in the national interest. But the government failed to issue such a directive when it intervened in Petro-Canada's purchase of Gulf Canada assets in 1985.

In order to prevent the misuse of Petro-Canada's social objectives in the future, the authors recommend minimizing Petro-Canada's role in policy formation and terminating its "window-on-the-industry" function. "Petro-Canada should not be involved directly or indirectly in any policy setting," they argue. In that vein, civil servants should not be allowed to sit on the board of directors of any Crown corporation that competes, or engages in joint ventures, with private-sector companies. Furthermore, the firm's objectives should be redefined to make them less vague, to suggest priorities if there are trade-offs between them, and to incorporate efficiency of operation as one of them.

Monitoring performance

To help monitor the company's performance more effectively, the authors suggest expanding the capital budgeting process. In particular, capital budgets should contain more detail; a larger staff at Energy, Mines and Resources should be devoted to examining those budgets; amendments to an already approved budget should be minimized; and Petro-Canada officials should be liable for more public information than their private-sector counterparts.

After comparing Petro-Canada's financial performance with that of private-sector companies in the same industry, the authors caution against using this evaluation test, especially for comparisons of profit and revenue. Since Crown firms operate under mandates that differ from those of privately owned companies, it is difficult to make such comparisons, they say, even after allowing for differences in accounting and financing practices.

Instead, the authors suggest an expanded audit that would, where possible, compare certain performance indicators (rather than output or profit indicators), such as productivity growth, exploration costs in conventional and non-conventional areas, and oil-sands technology and development. While such evaluation is possible in industries where private-sector firms operate, the authors suggest external auditing of performance or expenses in industries where the Crown firm is the major or sole operator. They also call for expanded use of written directives to augment or specify legislative objectives, or to signal a change in direction that the government might wish to see take place. This would allow for easier identification of the ultimate source of responsibility (political or other) for the company's activities.

In addition, the authors would substantially expand the role of the Standing Committee on Energy, Mines and Resources. The committee would be charged with reviewing Petro-Canada's annual reports, corporate summaries, and annual budgets and audits. It would have the right to call any official of Petro-Canada to testify before its members. It would also undertake its own annual evaluation of Petro-Canada, and it would have the budget and professional staff needed to handle these enhanced responsibilities.

As part of their study, the authors analysed the impact of Petro-Canada's formation and growth on the share prices of private-sector firms in the oil and gas sector. They conclude that the announcement of the creation of Petro-Canada was viewed with some trepidation by financial markets, in that the share prices (as measured by indexes) of companies fell in both the oil- and gas-production sectors and in integrated production. But none of the Crown firm's acquisitions since then would appear to have had any significant discernible impact on the financial performance of other firms in the oil and gas sector.

Petro-Canada: Its Role, Control and Operations, by Paul Halpern, André Plourde, and Leonard Waverman (EC22-147/1987E; $9.95 in Canada, $11.95 elsewhere).



Petro-Canada

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Lessons in innovative management

A key lesson for managers who are planning innovative changes in the workplace is that it is unwise to copy others.

While the principles and approaches to workplace innovation are transferable, each organization must design its own structures and processes to fit its own needs. The various parties in the organization must also go through the important learning process that comes from having to work together to identify problems and goals, says Toronto researcher Jacquie Mansell, in a study done for the Council's project on the labour market impacts of technological change. That project led earlier to a Council policy statement entitled *Making Technology Work* (see *Au Courant*, vol. 8, no. 1), along with other reports.

Mansell traces the development of new, more flexible ways of organizing work, many of which give employees a major role in determining how they are to carry out their work. These approaches include rotating employees among jobs; allowing them to carry out a variety of functions; setting up joint union/management committees; and creating "semi-autonomous work groups" (where each group is responsible for most aspects of its work, including planning, production, and some support activities, and where each member of the group is able to perform most of the tasks).

Successful innovation

The author looks at a number of case studies of successful workplace innovation, concluding that it is as important to Canada's economic future as new technologies. In fact, new technologies may force organizations to explore new methods of organizing work, she says. In many cases new technologies are more effective when there is innovation in the way the firm is organized and in relations between managers and employees. Workplace innovation has also led to significant benefits, Mansell notes, including lower costs and less absenteeism, and more challenging roles for workers.

Mansell draws some key lessons about the conditions necessary for successful innovation from the vast amount of evidence that has been accumulated over the past 15 years. In addition to noting that it is unwise to copy others, Mansell points out that innovation usually does not survive long if it has been limited to only part of the organization. In fact, the kinds of change that are most likely to produce the most significant results – such as the introduction of semi-autonomous work groups – eventually need to be implemented throughout the establishment if they are to last.

In addition, change cannot be implemented successfully without significant resources – funds; time; and, above all, people. "The right people have to be involved in, and in charge of, the change process," she says. People in key areas of influence within the organization must participate actively in the change process, and those who are respected throughout the organization must be in charge of it.

Finally, managers and unions should realize that the change process is not only intellectually demanding; it is also a highly political and emotional process. In this regard, workers cannot always be told what they ought to do: they insist on making their own mistakes. They will only be able to learn if they are prepared for, and able to cope with, some pain. That is why workplace innovation needs to be supported by strong, committed leaders and directly guided by mature and competent people, Mansell explains.

Other lessons

Two important lessons have also been learned about why successful innovation has sometimes not been sustained. First, within many organizations, innovation has been regarded as a product rather than an on-going process. People have not realized that there is no one best design that will always be most effective. As the environment within and outside the firm changes, so too must the design of workplace innovations.

Second, innovative organizations are limited by, and threaten, their environment. For example, the idea of semi-autonomous work groups is based on a fundamentally different set of values than are most organizations in Canada. In that sense, change cannot ultimately survive within organizations unless it is supported by changes at the societal level.

Workplace tensions

The author singles out two major sources of tension between innovative forms of work and the underlying fabric of the workplace in Canada. Both relate to the fundamental assumption that management will maintain control over the workplace, and the union will act as a "counter-organization" to limit management's control in specific areas such as job security and fair compensation. In the first instance, many corporations are not prepared to make fundamental changes to their management systems, which now support the role of the manager as decision maker and decision enforcer. Second, unions sometimes oppose innovation because many of the changes that management wants – for example, flexible job descriptions and work rules – threaten the current system of collective bargaining. Unless such threats are addressed in a creative manner, workplace innovation may ultimately weaken the trade union movement.

Innovation usually does not survive long if it has been limited to only part of the organization.

Workplace Innovation in Canada: Reflections on the Past . . . Prospects for the Future, by Jacquie Mansell (EC22-146/1987E; $4.95 in Canada. $5.95 elsewhere).

Air Canada's costly ownership

Government ownership may have cost Air Canada $370 million a year in additional expenditures between 1964 and 1981, according to a recent Council discussion paper.

Most of the additional costs were in the form of excess aircraft, which the airline probably had to purchase in order to meet government-imposed service requirements, the paper says. The airline may also have been more likely than other domestic air carriers to purchase new aircraft because, as a Crown corporation, its capital costs are perceived to be relatively lower. (The government backs the airline's debt, for example, making it less of a risk to creditors.) Cost inefficiencies at Air Canada also arose in the use of labour, fuel, and other purchased materials.

Since its inception, Air Canada has been pressured directly or indirectly to maintain what is perceived to be uneconomic service to some points in Canada. The federal government has also intervened in the airline's management on such matters as aircraft purchase, service standards, fuel consumption, and labour contract negotiations. In total, Crown ownership is believed to have added 18 per cent to Air Canada's total costs over the 1964-81 period, the paper concludes. Furthermore, because Air Canada is such a large player in the domestic airline industry, privatizing it would lead to an industrywide reduction in labour costs that would have amounted to $50 million in 1981. (These savings would probably be smaller today, because Air Canada has made substantial gains in cost efficiency as a result of both the liberalized regulatory framework and the introduction of the new *Air Canada Act* in 1977, which made the airline more market-oriented.)

The Council paper, which looks at the impact of government ownership and regulation on airline performance, was carried out as part of the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3). Authors David Gillen, Tae Oum, and Michael Tretheway compare Air Canada with other domestic carriers on the basis of productivity and cost efficiency.

On both counts Canada's regional carriers had a slightly better average performance over the 18-year period, primarily because they grew more rapidly during that time. While these carriers also operated to some degree with excess capital stock, Air Canada and, to a lesser extent, Canadian Pacific Airlines (now part of Canadian Airlines International) had the worst records in that regard. Air Canada's productivity performance was almost 25 per cent lower than CP Air's for that reason. While the authors were unable to pinpoint where Air Canada overexpanded its capacity, they suspect that it occurred with "both the number of aircraft and the purchase of larger aircraft than the market required."

As for the impact of government regulation on airline performance, the authors find that it, too, raised carriers' costs – by 7 per cent for Air Canada and CP Air, and by 17 per cent for the regional carriers. Again, the principal reason was the excess capital stock that carriers were induced to use. But most carriers have improved their cost efficiency since 1977, as a result of both regulatory relaxation and the introduction of competitive market forces. On the basis of what has occurred in other countries, the authors speculate that over the longer term the price of labour in the industry would decrease significantly in response to deregulation or the introduction of a more liberalized regulatory structure.

The authors point to a number of interesting results from their cost analysis. For example, they find that adding new destinations to a carrier's network will not, by itself, reduce average unit costs. In that sense, Air Canada, despite its size, may not have a cost advantage over other airlines. Carriers can reduce unit costs, however, by increasing traffic within existing markets. "A properly designed hub and spoke system which effectively increases the (traffic) density of any given network link could be desirable from a cost perspective," the authors explain.

In the past, regional carriers have suffered cost inefficiencies in their scheduled services by undertaking a large portion of charter business. One reason is that they needed larger, long-haul-oriented aircraft for charter services, while having only smaller, short-haul-oriented aircraft for scheduled services. As a result, they had to lease or acquire aircraft for charter services that could not be used for scheduled business (and vice versa). National carriers like Air Canada, on the other hand, could use their long-haul aircraft for both purposes. The regional airlines had been encouraged to seek growth in charter markets because of the Regional Carrier Policy, which restricted their routes geographically and thus limited their ability to expand scheduled services or to increase stage length. That policy, which was abolished in 1984, "had been very costly for Canada," the authors say.

"Identifying and measuring the impact of government ownership and regulation on airline performance," by David W. Gillen, Tae H. Oum, and Michael W. Tretheway. Discussion Paper No. 326.



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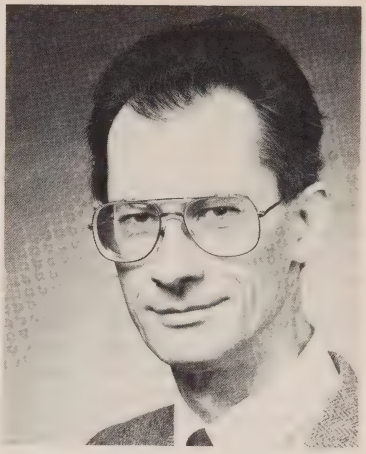
Canada's social policies are likely to become increasingly the target of reform, as governments respond to growing concerns about the efficiency and fairness of the social system.

In particular, a number of recent studies suggest that it is difficult to make progress in the fight against poverty in Canada. In 1981, almost 3.5 million Canadians fell below the low-income cutoff line, as defined by Statistics Canada. Despite the economic recovery since then, some 3.7 million Canadians remained below the cutoff line in 1986. (By now, the percentage of people living in poverty may have returned to 1981 levels.) In one year alone, Canada spent almost $16 billion to help people out of poverty. Studies also indicate that a serious problem of social-program dependency has developed in Canada. Some researchers claim that certain transfer programs actually contribute to poverty by reducing the incentive to work (thus creating a "poverty trap") and by distorting demographic choices (such as marriage, divorce, and birth rate). In many provinces, for example, welfare recipients are discouraged from taking part-time jobs because their benefits are reduced by an amount equal to the income they earn.

On several occasions in the past, the Council has turned its attention to the issues of income distribution, poverty, and social policy. (It played a pioneering role in the development of more accurate measurements of poverty in the late 1960s, for example.) To continue its work in that area, the Council recently launched a new project on social policy that will report its findings in early 1989. To find out more about it, *Au Courant* spoke with project director Sylvester Damus.

Au Courant: Why is the Council undertaking this project?

Damus: The whole area of social policy is likely to be high on government agendas over the next few years. The Council wants to be in a position to take part in that debate. At the same time, there is apparent reluctance to undertake reform of income-security programs because of the absence of research into the expected results. We are focusing our efforts on two fronts – the development



Sylvester Damus

of analytical instruments, so that decision makers can assess the merits of various reform proposals; and an assessment of how well the current system combats poverty.

Au Courant: What will the project be looking at specifically?

Damus: We are tackling three issues: the measurement of poverty; the dynamics of poverty; and the costs and benefits of tax and transfer programs. In the first two areas we are attempting to get a statistical picture of poverty and of the characteristics associated with people living in poverty. We will also be analysing the poverty experience of people over time, in order to identify the factors that influence the movement of various types of households in and out of poverty. We noticed in our tax research, for instance, that people's incomes fluctuate considerably, even though average incomes remain stable; therefore the need for income supplementation may be more widespread than is generally recognized. The third area is the modeling exercise, where we are developing a general equilibrium model of the economy to answer "what if" questions about possible changes to the tax and transfer systems. There are two objectives in the modeling exercise: to assess proposals for income-security reform in terms of how they affect income distribution, and with respect to the nature and extent of their economic costs; and to measure the impact on income-security programs of changes in the economy, such as technological progress, free trade, and industrial reorganization. We have already developed a model of the Ontario economy similar to the one that was developed in Quebec for its White Paper on the Personal Income Tax System. The central feature of the simulation model is its ability to analyse the effects of alternative tax and transfer schemes on labour supply and economic activity. An accessory to the model is an accounting model that translates the impact of existing or proposed tax rates, transfer benefits, and eligibility rules on representative socioeconomic groups. You can think of this accounting package as a cousin of some smart tax-planning software. The simulation model then determines the impact of these tax and transfer changes on labour supply, wages, prices, and incomes. This helps to determine what happens to the economy as people respond to changes in the tax and transfer systems. For example, how are you going to react if your social assistance benefits are increased or if your taxes are reduced? Will you spend more, and thus create jobs, or vice versa? There is a belief that high transfer payments discourage work effort by making it unattractive for recipients to return to work. Our model will help to focus the debate by putting such beliefs to the test.

Au Courant: Have you had any preliminary findings in this area?

Damus: We have had some interesting results with respect to the "trickle down" theory of economic growth. This theory holds that economic growth is like a tide that lifts all boats, in the sense that even the poor will experience some benefit as the economy grows. But what our results have made clear is that poverty depends not only on whether incomes are rising (as a result of economic growth), but also on the distribution of rising incomes and on whether transfer payments are increasing as well. So, in a macroeconomic sense, there are three factors that can reduce poverty over time: rising incomes, increased social assistance, and a more equal distribution of income. But these developments do not all necessarily

happen at the same time; nor do they always move in the same direction. Our research has shown that in some periods disparities among various income groups increased as overall incomes grew. We were able to identify broad, social economic groups that suffered a greater incidence of poverty during those periods. At other times, the rise in incomes resulting from economic growth was accompanied by a more equal distribution of income; and in those cases, poverty clearly diminished.

Au Courant: What has your research shown about the causes of poverty?

Damus: Actually, we are looking at the factors associated with poverty, not the causes. Let me explain. Suppose we discovered that 90 per cent of the poor had less than a grade 12 education. We could then conclude that not having finished high school is associated with poverty. But we couldn't identify that as a cause because there are reasons why those people didn't finish high school. In the course of our research, we would expect poverty to be associated with such factors as education, health, marriage, and labour market attachment (work experience).

Au Courant: You said you will be looking at the measurement and dynamics of poverty. Why?

Damus: There are a number of significant limitations in the way that poverty is currently measured. First, the poverty figures provide no information on the movement of various types of households in and out of poverty. While we know that some social-assistance beneficiaries are short-term recipients and others are long-term, we do not know the make-up of either group. A better understanding in this regard would enable us to judge more accurately whether the assistance programs are meeting actual needs. Second, poverty indicators do not take account of how far below the poverty line personal income lies. The result is that a helpful transfer program that increases household incomes without actually raising them above the poverty line may well have no effect on measured levels of poverty. Finally, there are numerous omissions in the income figures used to determine poverty levels and the poverty line in Canada. For example, subsidized housing, health services, and other special assistance are not taken into account in statistical measures of the resources of the poor; neither are assets. In the United States, a recent study concluded that there were almost 50 per cent fewer poor people when those transfers were taken into account.

There are a number of significant limitations in the way poverty is currently measured.

Au Courant: Where do you draw the line between who's poor and who isn't?

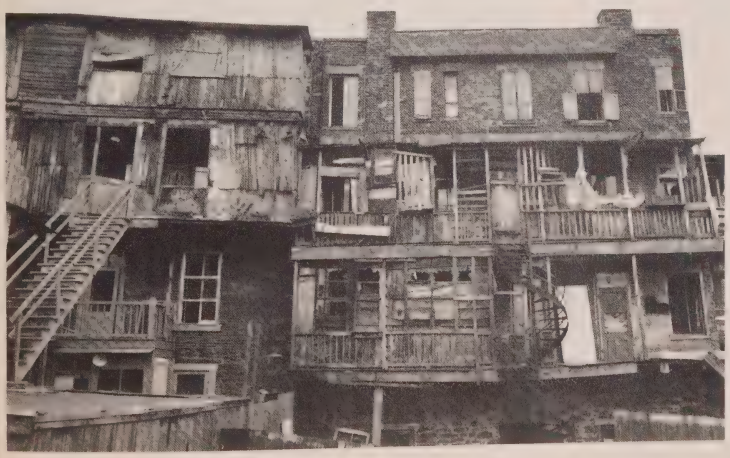
Damus: Some economists argue that you cannot draw a poverty line because it is misleading in the sense that some of the population will always be poorer than others. You will always have some poverty as long as you don't have a perfectly equal distribution of income, with everyone receiving the same amount, be it the prime minister or a high school drop-out. But if you look at poverty in the absolute sense, you recognize that the poor of today may be better off than the middle class of many years ago or that in Canada the poor are better off than they are in many other countries. But you can make some misleading statements from that perspective as well. For example, conditions that you might regard as progress in some countries could be perceived as shocking if you found them in Canada. So it's very difficult to draw a poverty line. What one can do instead, however, is to recognize the diversity of opinion as to where the line should fall or whether it should even be drawn. Then we can make a statement about whether poverty has increased or decreased with respect to that diversity of opinion. That is why, in developing new ways to measure poverty, we intend to put more emphasis on the distribution of income within a certain range.

Au Courant: At this stage, do you have a feel for the types of recommendations you will be putting forward?

Damus: Primarily we will be providing information that will be useful to policy makers. The project will not necessarily produce recommendations; rather, it will provide them with the information with which to make recommendations. It will produce the tools of analysis that will enable people to update information on poverty as time goes on and to analyse that data, including simulation of the probable consequences of various approaches to the relief of poverty.

Au Courant: Why is the Council shying away from making recommendations?

Damus: If areas emerge where we can make recommendations, we will; but the main objective is to lay the groundwork of research on which recommendations can later be formulated.



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Economic Council of Canada

Volume 8, No. 4, 1988



The free-trade deal
The record of adjustment

PUBLICATIONS

New Council Statements

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In this Statement, the Council looks at the adjustment of manufacturing firms and workers to changes in the marketplace, particularly the impact of growing international competition and trade liberalization. The Council presents considerable new evidence on the adjustment responses of Canadian and foreign-owned firms; on the mobility of workers; and on the impact of change in "trade-sensitive industries" – those that have received sector-specific government assistance because of the pressures of international competition. The Council also puts forward recommendations for governments on how best to help workers and industries manage the adjustment process.

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In this Statement, the Council assesses the impact of the proposed Canada-U.S. Free-Trade Agreement. In particular, it looks at the extent to which Canada achieved its objectives in the trade agreement; the impact of the agreement on economic growth and job creation in the economy as a whole and in various industries and regions; and some of the concerns that Canadians have about the deal. In addition, the Council puts forward some suggestions for helping workers adjust to changes in the economy as a result of the agreement.

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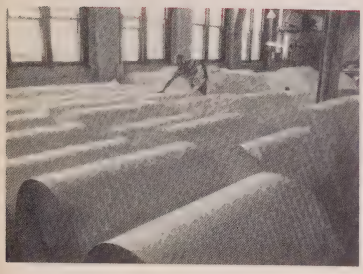
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Managing Adjustment



Some workers and industries in Canada have failed to adjust to increased foreign competition because of protectionist government policies that prevent rather than promote adjustment, the Economic Council says.

In particular, import quotas and subsidies have tended to delay workers and industries from making the appropriate choices indicated by competitive pressures, the Council says in a new Statement examining the adjustment experience of Canada's manufacturing sector. The research also indicates that, by and large, special industry policies "have had a low payoff."

The Council believes that special sectoral measures should be used sparingly and only after careful consideration and evaluation. It calls for a number of "corrective steps" to ensure that such policies have the intended impact of promoting positive adjustment. The conclusions and recommendations contained in *Managing Adjustment: Policies for Trade-Sensitive Industries* are the culmination of an 18-month research program. A more detailed report on the project's findings will be published shortly as well.

An overview

The Council points out that Canada's prosperity depends on trade and that its manufacturing sector produces two-thirds of Canada's exports. Because of the constant challenge to renew its products and production systems in response to international competition, "Canada must manage the adjustment to change by manufacturing firms and workers wisely," it says. "In managing adjustment, Canadians are trying to channel capital investment, managerial talent, and workers' skills into activities where they will be most productive."

Canadian manufacturing firms have faced a number of competitive challenges over the past two decades. The newly industrialized countries have undercut traditional industries – textiles, clothing, and footwear, in particular. The dynamic Japanese economy has displaced some Canadian production of goods such as automobiles, ships, and electrical appliances. As well, there have been rapid technological innovations; changes in transportation (including deregulation); fluctuations in exchange rates and the world price of oil; and increased import competition from the fall in tariff barriers.

In the past, the debate on adjustment policy in Canada has tended to focus on the particular problems of a specific industry. But two recent developments call for a broader perspective in examining this issue, the Council says. First, the negotiation of a Canada-U.S. trade agreement has awakened Canadians to the scope of the adjustment challenge facing all sectors that engage in international trade. Second, the economic success of Japan and the newly industrialized countries has forced Canadian firms to recognize that their competitors can replicate the production of many of the goods and services now produced in Canada. "In short, the adjustment challenge is pervasive and unending," the Council explains.

The research

To manage adjustment, it is not sufficient merely to identify the competitive pressures on the horizon. There is a need as well to understand the responses of industries, firms, and employees to the pressures of a changing environment and to assess how their responses influence policy makers. On the next few pages *Au Courant* presents considerable new research to describe the actual adjustment that is taking place in the manufacturing sector. Because the impact of structural change on unemployment is of critical concern, the Council concentrates on examining the turnover of jobs (initiated by firms) and the mobility of workers. Since foreign-owned corporations may react to the pressures for change differently than Canadian-owned firms, the Council looks at whether firm-initiated responses differ according to country of ownership. It also examines the impact of change on "trade-sensitive industries" – those that have received sector-specific government assistance because of the pressures of international competition. The analysis in this respect focuses on the use of three policy instruments: special import measures, particularly quantitative restraints on imports (quotas); capital subsidies to firms and industries; and special labour market policies. The Council examines the way in which these instruments have been applied in the shipbuilding, automobile, footwear, textile, clothing, and pulp and paper industries.

Finally, the Council sounds a note of caution over the increasing involvement of governments in adjustment policy, reflected in part by the growth in the number of trade-sensitive industries. "This is important because our work suggests that if change is delayed for too long as a result of sector-specific assistance by governments, the adjustment that must eventually take place will be far more difficult . . . for people in the affected industries," it concludes. Hence the Council puts forward recommendations for governments on how best to manage the adjustment process.

Adjustment in manufacturing

Will free trade with the United States lead to an exodus of foreign-owned branch plants – U.S. multinationals in particular?

New Council research suggests that a mass exodus is unlikely. Contrary to public perception, in fact, recent experience shows that many U.S. multinationals have maintained or expanded their Canadian presence as trade barriers between the two countries have fallen. Furthermore, while in many industries Canadian employment in U.S. branch plants has tended to decline relative to that in U.S. parent corporations, the losses tended to be smaller in those industries where Canadian trade barriers had been lowered the most.

It is often suggested that Canadian affiliates of multinational enterprises will respond to competitive pressures in ways that are less favourable to the domestic economy than are the responses of Canadian-owned firms. Proponents of this view argue that some forms of production may not be economically feasible in Canada in the absence of trade barriers.

To discover if ownership makes a difference in the way in which firms react to change, the Council examined the responses of multinationals to several types of pressures (including tariff reductions and differences in national cost levels). Specifically, it examined evidence on the inclination of U.S. and Australian, as well as Canadian, multinationals to shift production from country to country, to rationalize (by improving production or lowering costs, for example), or to cease operations in the face of import competition.

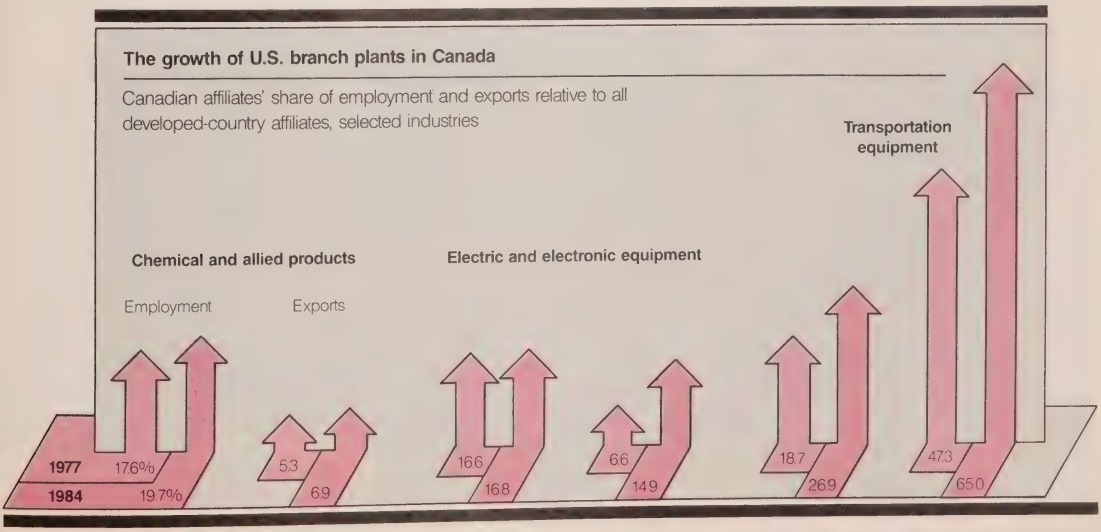
The results

The Council uncovered a number of interesting results. First, multinationals do not appear more inclined than other firms to shift their operations to low-cost foreign sources of inputs. They may even be less footloose than domestic firms: when there are short-term changes in the prices of competing imports (caused by variations in exchange rates, for example), multinationals show more stability in employment. That means domestic firms are more likely, for example, to buy cheaper foreign inputs and to lay off workers as a result of short-term price reductions in competing imports. (Conversely, they are more likely to hire workers in response to rising import prices.) Multinationals, on the other hand, respond much more strongly to longer-term changes in import prices. Consequently, the Council maintains that multinationals would appear to be "particularly well placed to distinguish between permanent (or structural) and temporary (or cyclical) changes."

Second, multinationals do not appear more inclined than domestic firms to close or sell plants when faced with declining domestic demand. "Thus the picture that is frequently painted of foreign-owned branch plants ready to leave Canada as soon as conditions take a turn for the worse is not borne out by the evidence," the Council finds.

Third, although there is some disagreement on this issue, foreign-owned firms in Canada appear to have rationalized their production facilities in response to trade liberalization and market growth in much the same manner and to much the same extent as Canadian-owned firms.

Fourth, in industries experiencing rapid trade growth (such as electrical machinery and transportation equipment), the affiliates of U.S. multinationals in Canada have grown in terms of exports and employment relative to those in other developed countries (see chart). Often, these are industries that involve a high intensity of research and development (R&D) and that "many hope will provide the high-quality jobs desired by Canadians," the Council points out. At the same time, Canadian affiliates of U.S.-owned firms have become less important in industries experiencing slower trade growth. This is particularly the case in



such industries as wood, paper products, and textiles. Canada's total share of developed-country exports in these industries also fell between 1977 and 1983, reflecting a decline in the attractiveness of Canadian production overall. In other instances, such as the food and beverage industry, while U.S. ownership of Canadian production became less attractive, Canada's share of developed-country exports increased.

In total, the evidence suggests that Canadian- and foreign-owned firms often respond to the pressures for change in much the same way.

In light of this evidence, the Council says that a separate adjustment policy based on the country of ownership of firms is not warranted.

Labour market turnover

The rationale for government intervention to help workers facing adjustment is much stronger than it is for firms, the Council believes. Workers may not have the resources necessary to undergo retraining, for example, while firms can more easily finance new investment opportunities. The Council looks at labour market adjustment in the manufacturing sector from two perspectives – "job turnover" (the creation and destruction of jobs) and "worker turnover" (the flows of workers into and out of jobs).

Job turnover is viewed as being firm-initiated, since it reflects the changes in employment that result from the creation, expansion, contraction, or closing down of firms. Each year, a large and relatively constant proportion of jobs in manufacturing disappear as a result of the decline or closing of firms – more than 8 per cent, on average, during the 1970s. When calculated over a five-year period – to eliminate the effect of short-run fluctuations – the average job-loss rate exceeds 4 per cent annually; over a 10-year period it is 3.6 per cent. "The latter figure reflects the fact that at least 30 per cent of the jobs that existed in 1971 had disappeared a decade later," the Council points out. Yet, as the accompanying chart shows, employment in the manufacturing sector has increased over time.

Worker turnover can be either firm-initiated (layoffs or hirings, for example) or worker-initiated (workers finding new jobs, for instance). Both are equally important on an annual basis. Together, the number of permanent layoffs and attritions (people quitting, taking early retirement, or extended leave for illness) amounts to more than 20 per cent of employment in the manufacturing sector each year.

Labour force mobility

While many people change jobs in the manufacturing sector each year, either for personal reasons or because of changing economic conditions, the large turnover does not necessarily mean that workers adapt easily. If workers leave one employer to do similar work for another in the same industry, it may be difficult for them to adjust should that industry undergo a long-term decline in activity. On the other hand, if workers move to other industries, occupations, or regions relatively frequently, "we can expect adjustment to be less painful," the Council explains.

The degree of labour mobility across occupations and employers was investigated by tracking individual workers over time. That evidence indicates that workers show "considerable mobility" between employers, industries, and occupations when they leave one job for another, the Council concludes. Still, adjustment problems are likely to be more acute in cases where the industrial base is narrow (such as in one-industry towns, for example) or where older workers in particular are affected, it adds.

Trade-sensitive industries

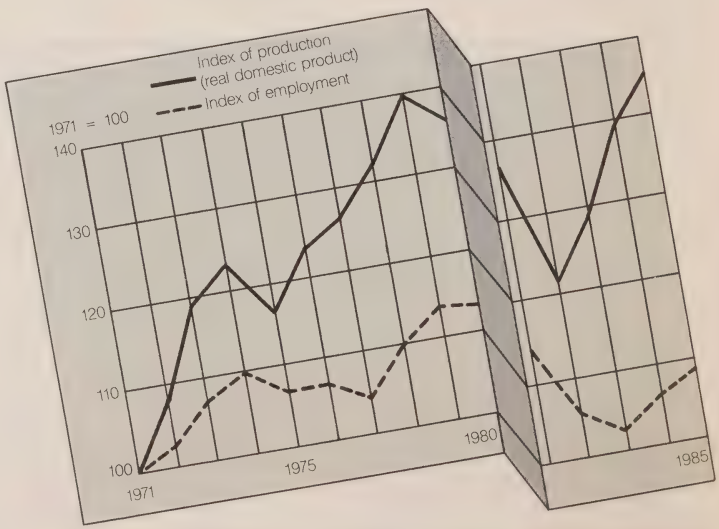
Some industries are likely to be more affected than others as a result of trade pressures. Adjustment problems are most acute for industries facing strong competition from imports. But the number of plant closures in these industries corresponds closely to those registered in other industries where there was less import competition, the Council discloses. Indicators of job and worker turnover also reveal little difference between the two groups of industries. In particular, the Council singled out for careful examination workers in four industries that are widely regarded as being among the most trade-sensitive: leather, textiles, knitting mills, and clothing. The mobility, and hence the adaptability, of workers in three of those industries turned out to be "remarkably similar to the average for all manufacturing," the Council found. Only the leather industry showed lower rates of layoff and attrition.

Trade adjustment

In industries that are experiencing declining sales, about half the adjustment takes place through a reduction in the number of new firms entering the industry. The other half occurs in the form of increased firm closures. In addition, industries grow not so much through lower firm-closure rates as through higher firm-entry rates. For workers, part of the adaptation takes place as those who would normally lose their jobs because of firm decline find new employment in businesses that are starting up.

The manufacturing sector has grown

Growth in production and employment; 1971 as the base year



A look at government policies

When the pressures for change are judged to be an intolerable burden on industries, regions, or workers, governments intervene with specific policies to manage that change.

Instead of promoting adjustment, however, many of the policies examined by the Council have retarded it. The Council analyses the impact of special import measures, subsidies, and labour adjustment measures on those industries in which they have been used most widely over the past 10 to 15 years: textiles and clothing; footwear; automobiles; shipbuilding; and pulp and paper.

Quotas

Special import measures were intended to provide a "breathing space" so that industries could adjust to increased foreign competition. When temporary quotas are introduced, for example, the industry is given time to adjust. In practice, however, special import measures have typically been of considerable duration, the Council finds. For example, at no time has an appropriate termination date been specified with respect to Japan's voluntary export restraints on automobiles. Under the General Agreement on Tariffs and Trade, the Multifibre Arrangement was basically supposed to encourage trade in textile products and to reduce trade barriers in that area in an orderly fashion. But it has become progressively more restrictive and has been renewed three times.

Subsidies

Subsidy programs have also fallen well short of encouraging positive adjustment, the Council says. Under the Shipbuilding Industry Assistance Program, the value of the subsidy was supposed to be reduced gradually over the life of the program. Instead, it was increased several times. In the case of textiles and clothing, although the subsidy program ended in 1986, the promised reduction in quantitative restraints has not taken place. Finally, although the Pulp and Paper Modernization Program was discontinued in 1984, the federal government continues to subsidize the industry under other programs.

Because import restraints and subsidies had tended to delay rather than promote adjustment, labour policies were given limited opportunity to demonstrate their usefulness, the Council explains.

The only bright spot in its analysis of policy implementation was the use of quantitative restraints in the footwear industry. Here, the quotas were announced as temporary and were indeed phased out.

Defining the problem

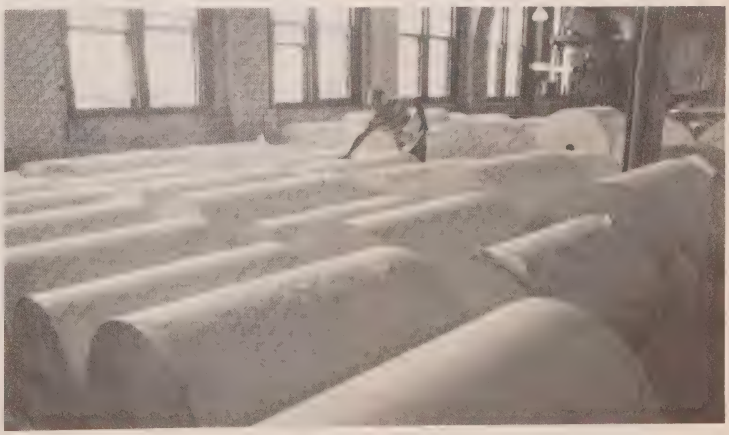
With the exception of the footwear industry, the Council finds that governments have failed to ask the right questions when considering adjustment assistance. Governments also have a serious credibility problem because of their failure to phase out or terminate assistance as originally intended. As a result, individuals and producers set their expectations accordingly, and adjustment is retarded.

Import quotas suffer from several problems in particular. Quotas generally restrict the level of imports, which causes higher import prices in Canada. In the case of selective quotas (targeted at a particular country or group of countries), foreign producers can realize a higher return on their exports than they would otherwise. Japanese auto companies are estimated to have garnered an additional U.S. $1 billion in profits in 1984 because of voluntary export restraints on sales to the United States, for example. Foreign producers that receive higher prices because of import restraints will be in a better position to maintain and improve their competitive advantage over domestic producers. This widening gap may discourage Canadian producers from using the breathing space to revitalize their operations.

Other shortcomings

The Council prefers global over selective quotas for other reasons as well. For example, because selective quotas usually target low-cost producers in a small number of countries, they may create an incentive for potential producers in other countries to manufacture those goods and ship them to Canada. If that happens, selective quotas can lead to requests for bilateral restraint agreements with the new suppliers. (This happened with automobiles and with textiles and clothing.) Global quotas that set a ceiling on imports from all sources do not suffer from those shortcomings, the Council notes.

Whether global or selective, however, when the size of the quota is set in volume terms (as it usually is), there is an incentive for exporters to shift to those categories of the restricted good where they can earn the highest profit margins. Such upgrading can occur in sectors of the market where domestic producers previously had an advantage. For example, Japan's voluntary export restraints on automobiles are believed to have accelerated the movement of Japanese manufacturers into the mid-size category, in which North American manufacturers had traditionally held a dominant market share.



The pulp and paper industry receives government support.

Employment and Immigration Canada

Directions for government

When industries or firms are in trouble because of competitive pressures, governments should help workers adapt rather than give subsidies to businesses to help them modernize, the Council concludes.

The subsidy programs examined by the Council have not promoted adjustment, despite their aims. Primarily, they did not encourage firms to undertake extra investment to modernize their capital equipment. "In contrast, there is a strong argument for government intervention to help workers adjust," the Council believes. Workers may need retraining, for example, and they may not have the necessary resources to adapt. So far, special sectoral labour adjustment policies have had a limited opportunity to demonstrate their usefulness because subsidies and other measures have retarded the adjustment process. But the design of such policies is consistent with the objective of encouraging workers to make the appropriate choices indicated by competitive pressures.

The Council's recommendation in this area is one of nine principles it puts forward to guide governments in managing adjustment and in dealing with the demand for intervention generated by competitive pressures. Overall, the Council sees an important and legitimate role for governments in the adjustment process at two distinct levels: the provision of general or framework adjustment policies in such areas as labour markets (unemployment insurance and training programs, for example), taxation, and competition policy; and the design of selected sectoral policies to help specific industries cope with adjustment.

In particular, governments should maintain and strengthen framework policies that encourage the most productive use of resources in ways that are least costly to society. While sector-specific policies should respect that principle as well, the Council recommends that they be considered exceptions, to be introduced only under particular conditions and subject to clear evaluation.

Quotas

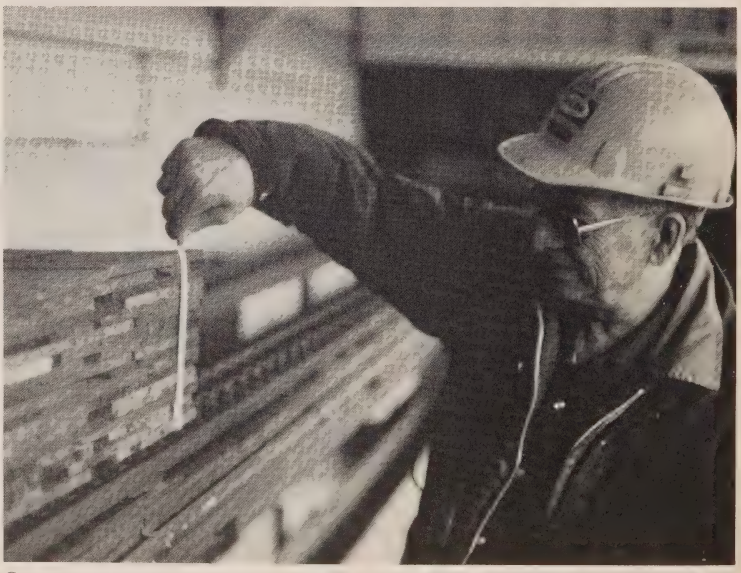
The Council supports the use of quotas to assist industries adversely affected by international competition, provided that Canada corrects the mistakes of the past. Where quotas are used, they should be global, not bilateral; temporary, not permanent; gradually phased out, not constant; and subject to a preset termination date.

To ensure the proper application of import quotas, the Council issues several guidelines. (Some of these principles could be applied to the adoption of other sectoral policies, such as subsidy programs, should the government persevere in using them.) When governments introduce sectoral policies (in particular, import quotas), they should first undertake a thorough evaluation of the problem, as well as of the costs and benefits of alternative policy options, including their duration, necessity, visibility, and impact on firm-adjustment options. The preferred policy should be implemented in such a way as to generate the information necessary for a retrospective evaluation. The public and interested parties should have access to both the initial assessment and subsequent evaluation process. If the urgency of the situation requires a quick reaction by government, the initial assessment may be undertaken after the policy is introduced.

Independent review

In considering the nature of the evaluation process, the Council is guided by four values that were laid down in its report on the regulatory process (*Responsible Regulation*, published in 1979): informed decision making; accountability; procedural fairness; and openness. One of the problems that regulatory boards experience in respecting those values is that they frequently become captured by the very industry they are regulating. "Agencies that confine themselves to one industry are more likely to be overwhelmed by its concerns," the Council explains. Hence it recommends that policy evaluation be undertaken by an independent arm's-length tribunal whose mandate is not confined to one industry or a small number of industries. The tribunal would hold hearings and issue written reports.

Because the Council is impressed by the mandate given to the Canadian Import Tribunal and the manner in which it undertook its various inquiries into the footwear industry in the early 1980s, it recommends that the tribunal be given responsibility in this area. The question of continuing the quotas should be referred to the tribunal within three years. The tribunal should also hold hearings



Employment and Immigration Canada

Governments should assist workers, not firms.

and issue written reports both before and after the quotas are imposed. In case of emergency, the policy evaluation may take place while some temporary import restraint is in place.

Distributing the benefits

In restricting imports through quotas, the government creates valuable commercial rights, since the price of the restricted goods in the Canadian market is higher than the world price. Sometimes Canadian importers benefit because the quota is allocated among them. (They import the restricted goods at the world price and resell them at a higher price.) In those cases the quota is divided up on the basis of historical import patterns. Other times the quota is allocated among foreign producers by their government, and hence they subsequently benefit.

The Council favours a system under which quotas are divided into standard lot sizes and then auctioned off. It sees a number of advantages to this method. Among other things, import restraint policies would be much more visible, because quotas would be given a dollar value – $3 for a pair of shoes, or $1,000 per automobile, for example. This would give voters and elected representatives a clear idea of their cost. If quotas are auctioned off, the windfall gain would accrue to the government, which could use the funds to respond to adjustment needs. Under this system, the quota holder could not use it as a competitive advantage to shut out new entrants and potentially reduce competition in the industry. Setting up auctions would also provide a clear indication of their tariff equivalent. This would raise the possibility of converting the quota to a tariff – generally considered to be a more efficient instrument of trade policy. While there are some perceived problems with quota auctions, the Council does not consider them insuperable. Hence it recommends that quota rights be auctioned off by the government in conformity with rules under the General Agreement on Tariffs and Trade (GATT), and that the results of such auctions be published. It also endorses the suggestion that auctioned quotas be used as an element in the proposed phase-out of the Multifibre Arrangement (which has restricted trade in textile products) under the GATT.

Governments may follow the recommendations concerning quotas but continue to protect the industry using other policy instruments once the quota expires. So the Council recommends that the Canadian Import Tribunal publish annually, on an industry-by-industry basis, a list of the instruments currently being used to protect an industry from international competition, as well as an estimate of the effect of each instrument by calculating the tariff that would be required to replace it with the same degree of protection. Because this is likely to be a major undertaking, the tribunal should initially confine itself to a narrow range of instruments (firm and industry subsidies, tariffs, government procurement, Canadian-content rules, and quantitative restrictions). Because such information can be collected relatively easily by foreign governments, its publication would not put Canada at a disadvantage in international trade negotiations, the Council points out.

> *Because of the difficulty in isolating trade-related job losses, assistance to workers should be part of general policies.*

Framework policies

Over the past few years the Council has recommended major changes to government policies in the fields of research and development, technological change, tax reform, and financial markets. General or framework policies in these and other areas must constantly be reviewed to make sure that they support rather than thwart adjustment.

In the case of labour adjustment policies, the Council believes it would be difficult to target special assistance to workers in trade-sensitive industries who are displaced as a result of changes in trade policy. One reason is the difficulty in isolating trade-related dislocation from that caused by other changes. Accordingly, it recommends that such assistance be part of framework policies designed to facilitate the adjustment of workers to changing economic times and conditions.

The Council's work on a number of programs aimed at workers adversely affected by changes in the marketplace leads it to make several suggestions as to how these programs might be modified or improved.

Preretirement programs

Income maintenance for older workers, in the form of preretirement benefits, has been one of the main elements in labour adjustment policies for trade-sensitive industries. Changes to these programs in the early 1980s enabled older workers to volunteer to be laid off without losing their eligibility for such benefits. As a result, younger workers are encouraged to enter and to stay in industries adversely affected by international competition, even though it might be more useful to encourage them to go elsewhere. Under the new Program for Older Worker Adjustment, the Council suggests a return to the eligibility criteria where workers are laid off according to their seniority.

In the past, the designation of industries and communities eligible for benefits under preretirement programs has been made by Cabinet. In the Council's view, consideration should be given to granting that responsibility to an independent tribunal such as the Labour Adjustment Review Board, since the board has labour and employer representation.

Re-employment programs

The Council notes that future job growth in Canada is likely to be in sectors requiring highly skilled labour. Hence it is important that workers be given the opportunity to upgrade their skills and education. In *Making Technology Work* (see *Au Courant*, vol. 8, no. 1), the Council made a number of suggestions for achieving a well-trained, flexible, and committed labour force. These included support for employer-based training in selected highly skilled occupations, the creation of conditions conducive to continuous learning on the job, and the provision of funds and leave for training. Rather than an increase in government funding in this area, the Council suggested a reallocation of resources, with a view to providing "an environment within which employers and workers can make informed decisions about necessary retooling and can then carry out the required training." It reiterates this suggestion, as well as calling for stronger support for the Industrial Adjustment Service (which encourages labour and management to work together when economic change causes labour market adjustments).

Bargaining over tech change

As the pace of change increases in the workplace, many Canadians become fearful that such change could cost them their jobs or lead to a reduction in their earnings. Many others fear that the introduction of new technology could make their work less interesting.

Because of those concerns, the Council undertook some research to discover what sort of protection Canadian workers enjoy against the adverse effects of technological change. As one measure of that protection, Council researcher Jonathan Peirce examined about 1,000 collective agreements on file in the Collective Bargaining Division of Labour Canada. The agreements covered workers in unionized establishments that employ 500 or more individuals. Peirce examined two things in particular: how frequently certain key tech-change clauses, such as the right to advance notification prior to the introduction of a workplace change, occur in Canadian agreements, and whether the incidence of any of these clauses has significantly increased over time.

The research was carried out as part of the Council's project on the labour market impacts of tech change, which led earlier to a Council policy statement entitled *Making Technology Work* (see *Au Courant*, vol. 8, no. 1).

The findings

Since tech-change legislation is in force in four Canadian jurisdictions (federally, in Manitoba, Saskatchewan, and British Columbia), Peirce studied whether tech-change clauses were appreciably more frequent in those areas. His findings were recently published in a new discussion paper. They indicate that, on the whole, tech-change clauses are not very frequent in Canadian agreements and that, furthermore, they are not all that much more common now than they were before the passage of federal and provincial tech-change legislation in the early 1970s.

The most common tech-change clause (that requiring advance notice and/or consultation prior to the introduction of a workplace change) occurs in fewer than two-fifths of the agreements in the sample. Other tech-change clauses, such as the right to retraining or relocation assistance, are still less frequent. And while tech-change clauses are somewhat more frequent in British Columbia and the federal jurisdiction than in Canada as a whole, they are relatively less common in Saskatchewan, and evidence suggests that, in general, the existence of tech-change legislation within a particular jurisdiction hasn't been much help to workers seeking to negotiate protective clauses.

Additional analysis

Workers under collective agreements covering 500 or more employees are not necessarily representative of the Canadian work force as a whole, since many people work in smaller establishments. Accordingly, Peirce supplemented his analysis of large agreements with a sample of about 200 small agreements (covering fewer than 500 workers). As might be expected, he found that bargaining unit size was a distinct advantage in obtaining protective agreement provisions. Every single tech change clause under study was relatively more common in the large agreement pool than in the small one. On average, workers covered by large agreements enjoyed an advantage of about three-to-two over their counterparts covered by small agreements.

In those jurisdictions that have tech change legislation in force, workers or their unions may request that the labour board enforce that legislation in cases where workers feel employers have violated it. But labour boards are not required to open bargaining over tech change when an application is brought before them; rather, it is an option that they may exercise at their discretion. To see how effective the legislation has been, Peirce looked at how often labour boards have granted leave to bargain and in what way they have interpreted that legislation. His review of the relevant labour board cases suggests that, except to a certain extent in B.C., workers and their unions have not been successful in bringing tech change cases before labour boards. The main reason, says Peirce, is the tendency of labour boards to adopt a highly restrictive definition of tech change.

New approaches

Peirce argues that, taken together, the results suggest that the Canadian collective-bargaining system generally hasn't accommodated itself very well to tech-change issues. Another observation is that more than half of Canadian workers are not unionized and thus do not enjoy any formalized tech-change protection, while many unionized public-sector workers do not have the right to bargain over this issue.

> *The collective bargaining system generally hasn't accommodated itself very well to technological change issues.*

Peirce concludes, therefore, that formal collective bargaining will need to be supplemented by policy approaches covering all workers if Canada is to create an industrial relations climate in which workplace change is more readily accepted by all parties. To this end, he suggests that joint labour/management committees be established in all workplaces employing 50 or more people. These committees should be given the mandate to address skills-related issues, such as job reclassification and tech-change-related retraining, in addition to bread-and-butter issues such as wages and job security. In unionized establishments, these committees would have to select their representatives from among active union members, in order to prevent them from usurping the unions' rightful business.

"Collective bargaining over technological change in Canada: A quantitative and historical analysis," by Jonathan C. Peirce. Discussion Paper No. 338.

Venturing Forth



The Canada-U.S. Free-Trade Agreement is basically a good agreement, the Economic Council concludes in a new Statement assessing the deal.

The Council believes that Canadians will be well served by the trade agreement. While acknowledging that Canada did not get everything it wanted from the deal, the agreement "is an important step forward," the Council says in Venturing Forth: An Evaluation of the Canada-U.S. Trade Agreement. Not only will trade barrier reductions boost growth in incomes, output, and productivity over the longer term, but also "the real (but not easily measured) gains to be derived from more-*secure* access may well match the measured economic benefits that flow from an *increase* in access." The Council's assessment of the deal is part of an ongoing project examining Canada's trade policy options (see *Au Courant*, vol. 7, no. 2).

From the beginning of the trade talks, Canada had four objectives: more-open access to the U.S. market for Canadian exports; more-secure access; special provision for sensitive sectors; and an example to the world of reciprocal trade liberalization and a model for the multilateral trade negotiations under the Uruguay Round of the General Agreement on Tariffs and Trade (GATT).

On tariff issues, access was achieved. (All tariffs between the two countries would be eliminated by 1998.) Since Canadian tariffs are generally higher than those of the United States, Canadian producers face certain adjustment pressures and costs, the Council notes. Canadian consumers, on the other hand, as well as Canadian producers who import parts, equipment, and raw materials subject to tariffs, will on average benefit more than their U.S. counterparts. On nontariff barriers, the gains were disappointing (about three-quarters of these barriers remain). In addition, while both countries are committed to liberalize government procurement policies, Canada was unable to obtain full access to nonmilitary defence, transportation, and telecommunications contracts. This is unfortunate, the Council says, because the U.S. Defence Department spends billions of dollars on research and development through university and other contracts not available to Canada.

As for more-secure access, new rules have been introduced to improve the security of access in such areas as services, investment, and energy. More-general rules to govern the conduct of trade and to help settle disputes have been developed as well.

Particular sectors have been singled out for special treatment, including agriculture, energy, automotive trade, services, and investment. In agriculture, the effect of the agreement on Canada's exports to and imports from the United States is not expected to be either significant or disruptive, although vegetable and fruit growers and some Canadian food processors will face adjustment pressures.

In energy trade, almost all bilateral barriers are eliminated. In this area, some Canadians are concerned because of provisions to maintain the traditional proportion of Canadian energy supplies to the United States in the event of world shortages. But Canada is already committed to an emergency oil-sharing system as a member of the International Energy Agency, the Council notes, and the new commitments with respect to natural gas and electricity correspond with the kind of support that Canadian suppliers would normally give to important customers. Furthermore, secure access to the U.S. market will reduce some of the market risks that tend to impede large-scale energy developments.

The bulk of the automotive industry will be relatively unaffected by free trade. Some small-parts manufacturing firms will likely have to restructure, and several of Canada's heavy-truck facilities may shift to the United States. In the service sector, the agreement is likely to have a minor impact on the flow of business services between the two countries. As for investment practices, Canadian negotiators managed to retain a screening mechanism for U.S. acquisitions of large Canadian businesses while securing exemption from any restraints on foreign investment in the United States. The issue of Canadian culture was not part of the agreement, apart from a few minor trade irritants that were resolved.

The agreement breaks new ground in spheres not yet covered by GATT, including trade in services, investment, and in particular the establishment of a bilateral tribunal with powers to override U.S. and Canadian administrative rulings in trade disputes. A mutually acceptable system of North American trade rules for dealing with unfair pricing, subsidies, antidumping and countervailing duties is to be negotiated over the next five to seven years.

Overall, the Council says the agreement does three things: it eliminates all tariff and some nontariff barriers; it establishes trade rules that will ensure a more predictable climate for commercial decisions on both sides of the border; and it will provide a forum for the more orderly handling of trade disputes, particularly when the new set of rules governing antidumping and countervailing duty cases has been worked out.

On the next few pages *Au Courant* examines the Council's assessment of the trade agreement.

The impact of free trade

Free trade with the United States will have a modest but positive impact on economic growth and job creation in Canada, according to new Council research.

By 1998 the trade agreement will have resulted in a 1.8 per cent increase in employment (about 250,000 jobs) and boosted real output by 2.5 per cent over the base case (where there is no change in Canada-U.S. trade relations), according to the most likely scenario in a series of simulations conducted by the Council as part of its assessment of the agreement. "While these numbers by themselves are impressive, they appear quite moderate when averaged over 10 years," the Council points out.

The Council bases its analysis on the expectation that the trade agreement will have two major consequences. First, the removal of tariff and nontariff barriers will lower prices and production costs, stimulate consumer expenditure and investment, and subsequently increase output and employment. Second, increased U.S. competition and more-open and -secure access to the American market will encourage Canadian manufacturing industries to rationalize production. By modernizing their facilities, attuning plant size to expanded sales, and finding appropriate specialized product niches, Canadian firms can substantially increase their productivity.

The Council says that the gains in output and employment under the free-trade deal are likely to be more modest than it had predicted earlier (see *Au Courant*, vol. 8, no. 2), because the actual agreement is not as all-embracing as the hypothetical deal it had simulated. As well, in the new simulations the Council distinguishes between two types of investment that lead to increased productivity – induced investment (that which normally occurs as a result of market growth) and autonomous investment (that which occurs in response to new markets and often from new discoveries and innovations).

The simulations

The Council undertook five simulations with these principles in mind. In Simulation 1, it simply removes the tariff and nontariff barriers to trade that are identified in the agreement. In Simulation 2, which the Council believes to be the most likely scenario, the removal of trade barriers is accompanied by induced investment that leads to growth in manufacturing productivity of 3.6 per cent a year (such growth normally averages 3 per cent a year). The results of Simulation 2 are summarized in the accompanying chart.

Over the long term, the benefits flowing from the security of access to the U.S. market and the new rules relating to commercial conduct could be higher than indicated by Simulation 2. For example, the provision of national treatment to investors who establish or acquire business enterprises, the new regulations governing services, as well as the commitment to remove disguised barriers to trade, will greatly reduce the economic and commercial risk of undertaking a new venture. In an attempt to capture the effects of additional autonomous investment that may take place as a result of the agreement, the Council performs two additional simulations in which total investment in the economy is increased in stages by 5 per cent overall. In Simulation 3, the additional investment is financed entirely from abroad; in Simulation 4, entirely from domestic savings. The Council says that its choice of a 5-per-cent increase in investment is based partly on a survey of major multinational firms, many of which indicated that their investment in Canada would likely increase by 10 to 20 per cent as a result of the trade agreement. Many small and medium-sized firms expect to increase their sales and invest in Canada in response to the agreement as well.

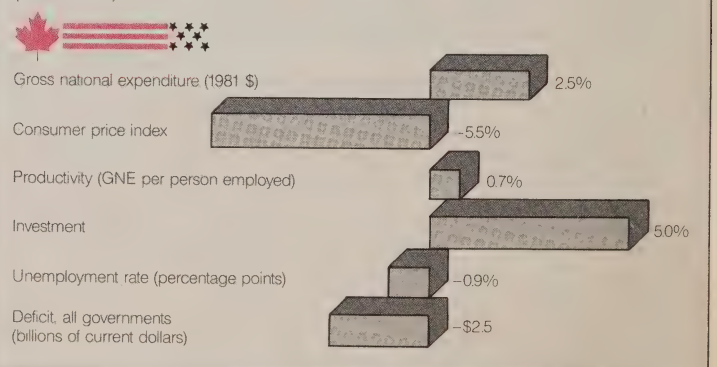
Finally, in Simulation 5 the Council looks at the impact of failure to ratify the agreement by measuring the effects on Canadian exports of U.S. trade actions that could be expected to follow if the agreement is rejected. This scenario also assumes that failure of the agreement would increase capital outflows from Canada by half a billion dollars annually. The result would be a decrease in Canadian output and a loss of some 22,000 jobs by 1998.

The Council also tests the sensitivity of its results to changes in the exchange rate caused by factors other than the agreement (such as an anticipated rise in commodity prices). A strong appreciation of the Canadian dollar would put a competitive strain on Canada's export industries. But by lowering the price of imports, it would also increase real incomes. The result would be a reduction in manufacturing activity and employment that would be more or less offset by growth in the service sector. The reverse would occur in the event of a strong depreciation of the dollar.

While the Council sounds a note of caution with respect to the accuracy of

The free-trade impact by 1988

Percentage and level changes over the Council's base-case projections (Simulation 2)



econometric projections in general, it points out that the simulation results "tell a consistent story." Ratification of the agreement will encourage increased economic growth and employment in Canada, it says. Conversely, failure to ratify the agreement would have a dampening effect on the economy.

Industry implications

To examine the effects of the agreement on various industries, the Council relies on what it describes as the most likely outcome, derived from Simulation 2. In this case, out of the 36 industries it examined, 29 would benefit from bilateral free trade. The service sector, primary industries, and construction account for close to 90 per cent of the gains in employment.

Within the manufacturing sector, 13 out of 20 industries would benefit, the most prominent being wood, primary metals, and printing and publishing. Those that could be adversely affected (primarily because they are highly protected by prevailing tariffs) are rubber and plastics products, leather products, textiles, knitting mills, chemical and chemical products, electrical products, and miscellaneous manufacturing. Within many industries, however, there will be winners and losers, the Council notes. Canadian high-fashion textile and wool producers are expected to benefit from free trade, for example, whereas producers of man-made fibres and cotton are likely at risk. In a similar vein, there are potential losers within some industries that are expected to benefit from free trade. While the food and beverage industry as a whole should benefit, for instance, wineries and some segments of the food processing industry are expected to face tough competitive pressures as trade barriers are eliminated.

To determine which industries will have to adapt in response to the trade deal, the Council looks at what would happen in the absence of productivity improvements under Simulation 1. In this case, increased U.S. competition could result in a net decline in output and employment in 17 of the 36 industries studied, virtually all of them in the manufacturing sector. Indeed, output for the entire sector could decline by 2.4 per cent relative to the base case if industries fail to improve their productivity performance. The Council concludes that "if Canadian manufacturing firms are to prosper in a free-trade environment, they must be prepared to modernize their plants and to upgrade the skills of their work force."

Provincial impacts

The impact of free trade on each province is largely shaped by its profile of industrial activities. According to the most likely outcome, all provincial economies will experience increases in output and employment. Western and eastern provinces will gain the most in relative terms, mainly because of the importance of primary industries that benefit from the removal of U.S. trade barriers. The gains for Ontario and Quebec, on the other hand, are slightly below the national average. That's because the picture for manufacturing, while positive overall, is mixed, owing in part to the failure to get broad access to U.S. government procurement.

Employment

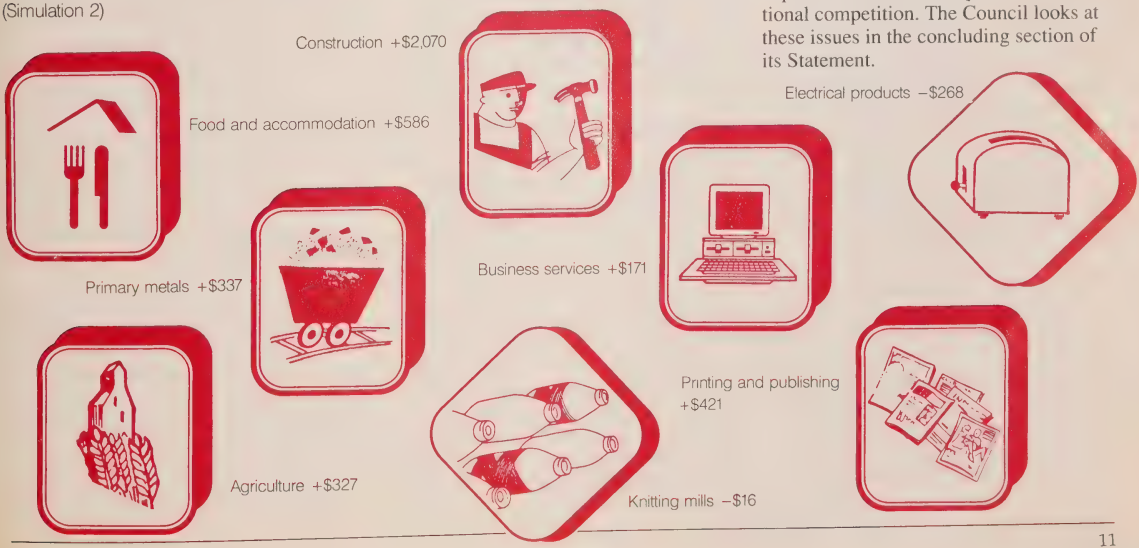
Of the 250,000 new jobs that would be created by free trade under the most likely scenario, service sector occupations – clerical, sales and services, managerial and administrative – dominate, accounting for close to 148,000 new jobs. Free trade will add about 37,500 new jobs to the construction industry, with the rest split mainly between manufacturing and primary industries. It appears that the job gains would be divided between men and women roughly in the same 60/40 ratio that is found in today's labour force. But the Council cautions against making definitive estimates in this respect, since they apply today's job gender split to the future.

The Council notes that the number of jobs created and destroyed over the 10-year span is not large in comparison to those that appear and disappear each year. The net gain in employment under free trade amounts to 25,000 jobs each year, for example, compared to increases of 250,000 to 350,000 jobs that normally occur annually.

The Council adds, however, that some of the people displaced by free trade will be those with years of experience, with families, homes, pension entitlements, and skills that may or may not be easily transferable. As well, many Canadians are concerned about the impact of the agreement on Canada's unique institutions, its trade laws, and on its ability to cope with the broader aspects of international competition. The Council looks at these issues in the concluding section of its Statement.

Some free-trade winners and losers

Increase or decrease in output (millions 1981 $)
(Simulation 2)



Assessing the deal

Canada will become a stronger and more cohesive nation as a result of its trade agreement with the United States, the Council concludes.

In its view, the two countries have negotiated "a historic and mutually beneficial treaty." But, while both countries will be well served by the agreement, the Council recognizes that many Canadians have deep reservations about it.

First, some Canadians have expressed concerns that the agreement could lead to an exodus of many U.S.-owned subsidiaries that, in the absence of trade barriers, may find it more profitable to supply the Canadian market from the United States. But there is little evidence to support this contention, the Council argues. For one thing, employment by U.S. multinationals in Canada has been strongest in industries where trade barriers between the two countries have been falling (see story on page 3).

On the other hand, some Canadians are concerned that easing Investment Canada's threshold review powers could unleash a wave of American takeovers and U.S. investment in Canada that could undermine Canadian sovereignty. (Under the agreement, the agency would generally be limited to reviewing U.S. takeovers of businesses with more than $150 million, as opposed to the current $5-million level.) Consequently, even with the new thresholds, it is estimated that Investment Canada will still have right of review over about two-thirds of Canadian-controlled assets. Under the trade agreement, with the exception of certain performance requirements, the existing criteria for evaluating large acquisitions can still be used. In addition, Investment Canada retains its existing full rights of review over acquisitions in the sensitive investment areas of energy, transportation, and culture.

Pressures to harmonize

A third area of concern is that the agreement will give rise to pressures that eventually reduce or alter Canada's social and regional development policies to bring them in line with U.S. practices. Both countries were at pains to remove their social programs from the negotiations, however, and Canada resisted efforts to bring culture, regional incentives or intellectual property into the negotiations. Furthermore, as Canada-U.S. trade interdependency has grown over the last four decades, the differences between Canadian and American social programs have, if anything, increased. Countries within the European Economic Community and the European Free Trade Association have not harmonized their social policies either. Furthermore, the rules under the General Agreement on Tariffs and Trade (GATT) are explicit in stating that trade laws cannot legitimately be invoked against social or industrial policies that are designed solely to cross-subsidize or redistribute income and employment among regions and citizens.

Finally, a major concern among many Canadians is the possibility of being displaced by the trade agreement and the prospects for them finding more satisfying, more remunerative alternative jobs. While such fears are understandable, the Council points out that as tariff levels have dropped significantly over the past 40 years, Canada has enjoyed the most rapid rate of employment growth of any developed country.

Adjustment programs

Governments must be willing to work out ways to ease the adjustment and to facilitate the retraining and re-employment of workers whose jobs are at risk, the Council says. It reiterates suggestions made in its other reports that adjustment programs should focus on workers. In particular, governments should review or, if necessary, consider new programs to ensure adequate access to income support and to alternative training opportunities for workers who are adversely affected. The Council also believes that strengthened or new adjustment programs should apply to workers who are displaced, not only as a result of the agreement, but also for other reasons – for instance, new technology. In other words, labour market programs should be general in their application and designed to meet the needs of workers who face the most difficulty in finding and holding a new job. In this vein, older workers, people with low education, and those who live in small remote communities should be the main targets of government assistance, the Council concludes.

As a small trading nation, Canada's external commercial policy should focus on trade liberalization and ways to strengthen the multilateral trading system to ensure the best possible access to all markets. The Canada-U.S. trade agreement is consistent with the general aims of both countries in multilateral negotiations under the GATT, and in certain areas it breaks new ground, the Council points out.

> *Governments must be willing to work out ways to ease the adjustment and to facilitate the retraining and re-employment of workers.*

The negotiations that follow the agreement are particularly crucial for Canada. Clear, mutually accepted rules of trade will help to reduce uncertainty and unnecessary litigation, for example. The Council believes that a top priority for Canada in future negotiations is to obtain greatly increased access to U.S. government expenditures on research and development. As well, the Council agrees that unless Canada is exempted from the application of the U.S. omnibus trade bill, it should withdraw its consent to the free-trade agreement.

(One Council member dissented from the Statement, questioning many of the Council's assumptions and arguing that the free-trade deal as currently structured is not in Canada's best interests. Two Council members also commented on the Statement; in their opinion the Council did not adequately examine the potentially negative impacts of the free-trade deal.)

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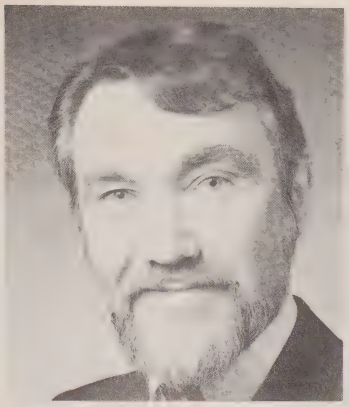
The Canadian and world economies are likely to undergo massive changes in the 1990s and beyond, in response to developments in such fields as science and technology. To find out what these changes mean for Canada's policy agenda, the Economic Council is undertaking a new project entitled Visions of Canada in the Year 2000. *Au Courant* spoke with project director Keith Newton to learn more about it.

Au Courant: How did this project come about?

Newton: To mark the 25th anniversary of the Council, the Chairman urged a departure from our traditional work. In fact, we are doing something out of the ordinary in this project, in three respects. First, rather than concentrate on purely economic questions, we are looking at some trends and prospects in such disciplines as political science and in areas such as science and technology, the environment, and demography. In that sense the project has a much broader focus than that of the work we traditionally do. Second, rather than dealing strictly with Canadian issues, we are trying to look at the prospects for Canada in the context of global trends and developments. Third, while the emphasis of the Council's research has traditionally been on the medium term – say, five to eight years from now – this time we are looking a little further ahead. In particular, we hope to identify the public-policy issues that this country will face as it enters the next millennium. From the Council's point of view, the attraction of this project is that the results should help us to develop the research agenda that this organization will need to address in the years ahead.

Au Courant: How will you go about doing this?

Newton: We are going to get the help of some of the very best minds in their respective fields. We expect contributions from scholars with international reputations, which is what makes this project a particularly exciting one. Some of our authors include Jacques Lesourne of the Conservatoire des arts et métiers in Paris and John Helliwell of the University of British Columbia,



Keith Newton

both specialists in international economics; Richard Freeman of Harvard University, who has done extensive work in the field of human resources; and Thomas Kochan of the Massachussetts Institute of Technology, who specializes in industrial relations.

Au Courant: How will the work be organized?

Newton: The project will be divided into four parts or blocks. In the first block, we shall be looking at international trends, not only from the point of view of economics but also in light of the shifting political alliances that may shape the face of the globe in the year 2000. We shall also be examining some of the world's environmental issues, population pressures, and trends and developments in science and technology.

In the second block, we shall be asking what these influences mean for Canada and its place in the world economy and what impact these developments will have on income distribution and social welfare policies in Canada.

The third part focuses on human resource development, including an examination of such issues as the education and training needs of the work force, the future of industrial relations, and the impact of changing technologies.

In the final block, we shall take a look at some of the recent trends and developments in the discipline of economics – in particular, at the process of economic decision making and the role of consensus in that process. Is there evidence, for example, that economies perform better when there is a consensus approach to economic decision making? We shall be doing some soul-searching as to whether the discipline of economics is too isolated, in the sense that we often analyse public-policy issues from a narrowly economic perspective only.

Au Courant: What do you foresee as the results of this project?

Newton: I think the most important output will be the intellectual capital that we shall get from bringing together leading scholars to discuss issues and ideas, and to raise questions about developments in their particular fields of expertise. Undoubtedly this will provide us with some directions for the future work of this organization. In early April we held a workshop in Ottawa to discuss the outlines of the papers that these scholars are working on. The papers will form the basis of a chapter in the Council's Twenty-Fifth Annual Review of the economy. Then, in late 1988, we shall be holding a major conference to discuss the papers and obtain feedback. Finally, we shall publish conference proceedings based on the presentations of the principal authors and the discussions that ensue.

Au Courant: Is it really possible to look into the future like this and come up with some meaningful conclusions, considering how quickly things change?

Newton: Most economists consider the range of uncertainty very great at the moment. Nevertheless, this exercise should complement the work we usually do, which involves engaging in very sophisticated modeling to look at some possible future trends and their implications for the future performance of the economy. This project is somewhat different in that we are not relying on an explicit modeling exercise; rather, we are relying on the views of people whom we believe to be particularly sage in their respective fields – people whose collective wisdom will help to shape our future.

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Over the past two decades, the Council has focused on public policy issues of key importance to Canadians — including economic growth, the role of new technology, the impact of government regulation and the changing job market, to name only a few.

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Economic Council of Canada

Volume 9, No. 1, 1988

Conference on Prairie agriculture



Evidence on job creation

Perspectives on regional development

New project on the service economy

PUBLICATIONS

New Council Report

Adjustment Policies for Trade-Sensitive Industries (EC22-152/1988E; $9.95 in Canada, $11.95 elsewhere).

This research report provides the detailed analytical findings that support the Council's Statement on managing adjustment in the manufacturing sector. The report looks at the adjustment of manufacturing firms and workers to changes in the marketplace, particularly the impact of growing international competition. It presents considerable new evidence on the adjustment responses of Canadian and foreign-owned firms; on the mobility of workers; and on the impact of change in "trade-sensitive industries" – those which have received sector-specific government assistance because of the pressures of international competition.

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than to the Council. One new title has been published since the last issue of *Au Courant*.

Creating Jobs in the Private Sector: Evidence from the Canadian Employment Tax Credit Program, by *Surendra Gera* (EC22-148/1988E; $8.95 in Canada, $10.75 elsewhere).

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the sole responsibility of the author, or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 344 "Open borders: An assessment of the Canada-U.S. Free-Trade Agreement," by *S. Magun*, *S. Rao*, *B. Lodh*, *L. Lavallée*, and *J. Peirce*.

No. 345 "Trade-related, sector-specific industrial adjustment policies in Canada: An analysis of textile, clothing, and footwear industries," by *Jaleel Ahmad*.

No. 346 "Commerce sans frontières – Une évaluation de l'Accord de libre-échange entre le Canada et les États-Unis," by *S. Magun*, *S. Rao*, *B. Lodh*, *L. Lavallée*, and *J. Peirce*.

No. 347 "Trade liberalization and international investment," by *A. Rugman*.

No. 348 "The Canada-U.S. Free-Trade Agreement: Possible implications on Canada's health care systems," by *Pran Manga*.

No. 349 "Concentration and competition in the financial sector," by *Andrée Mayrand*.

No. 350 "Pulp and paper modernization grants program: An assessment," by *K. E. A. de Silva*.

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

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Volume 9, No. 1, 1988

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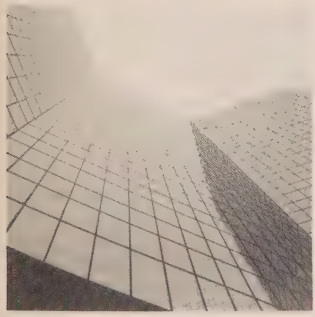
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The future of Prairie agriculture

Prairie agriculture is in trouble. Not only have western Canadian farmers had to struggle through such natural disasters as drought and grasshopper infestation in recent years, but falling wheat prices have left many of them in financial difficulty. Were it not for substantial government assistance, in fact, net farm incomes on Prairie farms would be close to zero today.

Despite the downturn in agricultural fortunes, Prairie agriculture remains an important economic activity. In 1986 it contributed about $6.4 billion to Canada's gross domestic product, much of it in export earnings. Moreover, the health of the agricultural sector affects the whole gamut of industries tied into agricultural production – from fertilizer producers and dealers, and farm machinery manufacturers, to fuel suppliers, grain pools, and transportation companies.

What lies ahead for Prairie agriculture? How should policy makers and farmers prepare for future world markets? The Economic Council is examining these and other questions in its project on the Future of the Prairie Grain Economy – the first Council project to be jointly financed by the private sector and various governments. As part of that project, the Council took part in a Conference on the Future of Prairie Agriculture in Saskatoon in late March. The conference was sponsored by the University of Saskatchewan and supported by the Economic Council.

Andy Schmitz, who heads the Council's agriculture project, and Caroline Pestieau, Deputy Chairman of the Council, co-chaired the two-day conference, which attracted some 220 delegates, including farmers, bankers, community leaders, fertilizer and farm machinery companies, government officials, and others with a stake in the western farm economy. Participants were presented with the highlights of original research being undertaken by the Council as part of its agriculture project. The idea was to provide new information to farming organizations and others with a stake in the Prairie grain economy, to get feedback on research findings from the Council project, and to provide an opportunity for input into the policy recommendations that will be drawn up by the Council later this year. *Au Courant* attended the conference and files this report.



International perspectives

Will Canada be competitive in world grain markets in the future?

Much depends on what happens outside Canada, according to Professor Alex McCalla of the University of California at Berkeley. Professor McCalla outlined the structure and changing patterns of world grain production, consumption, and trade, and he examined possible future trends and their implications for Canada.

Over the past 20 years developed countries have become relatively more important as grain exporters, while the developing countries and centrally planned economies (Russia, in particular) have become major importers (see chart). In particular, the United States has changed from an insignificant trader to the dominant exporter. Western Europe has become a major exporter as well. Canadian grain exports have doubled since the early 1960s, and Australia and Argentina remain influential exporters. Russia, which had been a major exporter until 1970, has become a highly variable importer. Most developing countries, particularly those in Asia and North Africa, have become major importers. Thus the pattern of trade is now one of few exporters and many importers, McCalla explained.

Trends for Canada tend to mirror these developments. The share of Canadian grain exports destined for developed countries has fallen by over 300 per cent since 1960, while Canadian exports to the developing nations doubled over the 1960-85 period. As well, nearly 50 per cent of Canada's grain exports are destined for centrally planned economies, much of them going to Russia.

Production and trade

Between 1960 and 1985, world wheat production more than doubled – from 238 million metric tonnes (mmt) to 503 mmt. Trade in wheat also increased rapidly over that period (from 44 mmt to 93 mmt). Almost all of the increase in production was due to increased yields (rather than any dramatic increase in the area of land harvested). While production of coarse grains (corn, barley, oats, and so on) nearly doubled over that period, the growth in trade of those commodities outstripped that of wheat. Coarse grains are used primarily

for livestock production. The use of wheat as a feed grain for livestock also increased more rapidly than production or trade in either wheat or feed grains. Furthermore, the market for medium-quality wheats is by far the largest and fastest-growing. The market for high-quality wheats, on the other hand, is growing very slowly. The implications of these developments for a Canadian wheat economy based primarily on high-grade, low-yielding varieties for human consumption should be carefully considered as Canada examines its future export prospects, McCalla pointed out.

Price instability

While grain prices remained relatively stable until the 1970s, they rose dramatically over that decade and then fell precipitously in the 1980s. Much of the price drop can be attributed to increased productivity (better yields) and excess supply. But domestic policies in many countries have added to the instability by encouraging rapid expansion in the grain sector, McCalla said.

In particular, U.S. farm policy has a significant influence on world markets. The rigid expansionist agri-policies adopted by the United States in the 1970s contributed to the boom mentality and high growth in grain exports during that period. But by the mid-1980s the U.S. share of world grain exports had plunged markedly, as other grain producers increased production. That led to the current "siege mentality," McCalla explained, whereby the United States continues to subsidize exports aggressively in an attempt to gain back its market share. Similarly, the phenomenal growth in grain production within the European Economic Community (EEC) is largely the result of its price support system under the Common Agricultural Policy. The result of these and other expansionist policies has been an escalating grain trade war.

Future trends

McCalla said that based on the current glut in grain markets, trade in this sector is likely to be stagnant into the early 1990s. In the short term, the domestic-policy responses of major exporters will continue to affect grain markets, but in the long term, "economic variables will dominate," he said. The case of India and of China may also have serious ramifications on trade in world grain markets. India's ability to feed itself and to become a small exporter in recent years could be replicated in other less developed countries, subsequently reducing the export markets for Canada and the developed world. In the medium term, China could dramatically alter the current balance in export markets by buying up more imports.

For Canada, the choices are limited. Much of what happens in world markets is "beyond Canada's control," McCalla said. What is vital to the future, he suggested, is cooperation and a multilateral approach to solving problems. Canada must also develop flexible policies that can respond to the significant changes that are likely to occur in the future. "With appropriate forethought a viable future can emerge," he concluded.

At the same time, many Canadians are concerned about the impact of U.S. actions on Canada. McCalla said that exporters in that country are "hung up" on maintaining their market share, despite the dampening effect on prices and the U.S. government's desire for a free market. It is unlikely that U.S. agricultural policy will change significantly in the near future, he said. The feed grain market may present opportunities, however, because of the expected growth in that area and the fact that U.S. exporters are relatively less concerned about their market share in feed grains.

Looking ahead

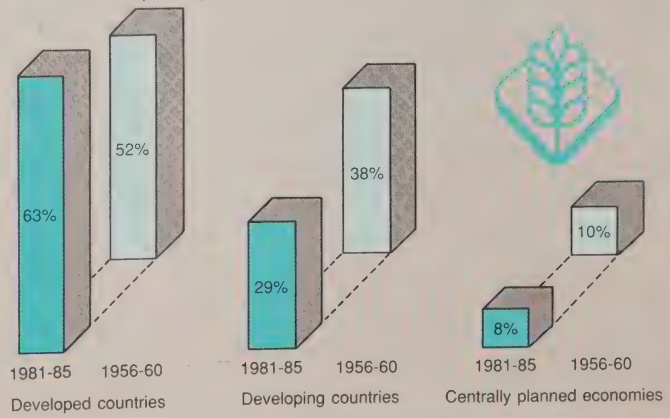
While the world demand for grain products is expected to grow in the medium term, the price of such products will depend heavily on U.S. government policies.

Canada is a major exporter of wheat, canola, and, to a smaller extent, coarse grains. But it does not set the world price for those commodities. Much of the price setting for cereals and oilseeds occurs in the United States and is influenced by the U.S. loan rate to farmers, the level of U.S. export subsidies, and the amount of U.S. government-held stocks. As a result, Canadian grain farmers face an uncertain future in the short term, Professor Hartley Furtan of the University of Saskatchewan told conference delegates. But in the long term the outlook for grain and oilseed prices is "rather optimistic," Furtan said in his forecast for grain markets.

By far the largest percentage of most Canadian grains are exported. Hence the future of the Prairie grain economy depends on developments in the world markets for wheat, coarse grains, and oilseeds. The largest producers of these crops are China, Europe, Russia, the United States, and Canada; the largest consumers are China, India, and Pakistan, which collectively represent more than half the world's population. While the volume of trade and export prices for grains depend on changes in the consumption and production balances in the major producing and consuming countries, Furtan argued that the policies set in the United States are key to the future of the Prairie grain economy. Other factors that will have a major influence on grain markets are income and population growth, weather conditions, and technological change.

Trends in agricultural trade

Share of world exports by region, agricultural and forestry products



Wheat

Assuming no dramatic changes in world wheat markets as a result of weather conditions, wheat prices are not expected to improve significantly until 1993, when world stocks are expected to drop (in relation to total consumption) to 20 per cent or lower. Should major producers respond by increasing production at that point, however, prices will remain stagnant. Meanwhile, global wheat production will continue to grow but at a rate slower than in the past 20 years, with China and Russia having the potential for large production increases. Canadian wheat production is expected to stabilize, and exports will fall marginally. The United States will continue to be the largest exporter and may step up production as wheat prices increase. (The United States has removed some 20 million acres from production since 1981, Furtan noted.) World wheat consumption will rise as well – primarily in developing countries, where income and population growth will be steady. China holds the most potential for increased wheat consumption, Furtan said.

Coarse grains

Coarse grain prices are expected to start rising in the early 1990s, as consumption outstrips production and stocks decline significantly. (Prices could respond sooner if China does not increase production or if it raises imports.) Current stocks, which stand at about a quarter of total world consumption, will have to decline to at least 16 per cent before prices rise significantly, Furtan predicted. In response to falling stocks and the expected rise in prices, major producing countries may increase production.

The future demand for coarse grains is linked to the demand for meats. In this regard, Pacific Rim countries represent a significant potential market. While corn is the major coarse grain and the United States dominates in world production, barley and wheat can compete in this market, especially in poultry production, Furtan pointed out.

Oilseeds

The world market for oilseeds (canola, flax, and soybeans) is expected to experience the strongest growth over the medium term. The current balance in world supply and demand will also favour strong prices in the near future. Production is expected to rise steadily to the mid-1990s, with the United States accounting for the largest increase. There may be room in the market for Canada to expand its production faster than it has over the past two decades, Furtan disclosed.

Canola production and exports have become increasingly important in western Canada, with Japan being the major importer of Canadian canola; recently, however, European producers have been challenging Canada in this market. At the same time, China represents a potential new market for Canada. And while traditionally there have been few policies in Canada to support domestic processing of oilseeds, Furtan sees opportunities in this area as well. Canola meal is used in animal feeding in competition with soybean meal. In addition, Canadian oilseed exports to the United States have increased markedly in recent years, largely as a result of the U.S. government's decision to grant status to canola oil as a generally safe product.



Employment and Immigration Canada

Grain prices will remain low in the short term.

Important markets

In the immediate future, Russia, China, and Japan will continue to be Canada's largest grain markets, Furtan said. If Canada were to lose any of these three markets, the income to Prairie producers would be seriously eroded, he pointed out. At the same time, policies are needed to help expand the economies of the developing countries, since they represent important markets for Canada and the developed world. At home, Furtan said that in the short term there is no alternative but for Canada to continue providing special grain subsidies to help Prairie producers.

The trading environment

Prairie grain farmers would benefit from free trade in agriculture, new Council research indicates.

Prairie agriculture would be competitive in a world trading environment if competitors' subsidies were removed, according to Professor Colin Carter of the University of California at Berkeley. Professor Carter reported on his research into the magnitude of agricultural trade subsidies worldwide and the implications for Canada of a more liberalized trading regime.

To measure the potential impact of free trade in agriculture, Carter examined 10 different models of global agricultural trade. The models were constructed for varying purposes, but several of them are capable of projecting the likely outcome under freer trade, he explained. Overall, the global gains from removing trade barriers (agricultural subsidies and support programs) would be significant – anywhere from $22.5 billion to $74.9 billion a year in increased incomes for both producers and consumers. Under each model, grain prices would rise, while production would remain relatively stable and possibly fall off in some cases (wheat, in particular). The potential impact on net world trade in agricultural commodities is mixed, with a possible decline under some models and an increase under others.

The effect of trade liberalization on a country's producers depends to a large extent on the level of government assistance they currently receive, Carter explained. Because of the high farm subsidies in the United States, for example, the price increases associated with trade liberalization may not offset the drop in producers' incomes once support programs are discontinued. In Canada, on the other hand, the

price increases from trade liberalization are more likely to offset the elimination of grain subsidies to producers, he said. Another concern is that the effect of trade liberalization may not be nearly as great in reducing output as protectionism was in increasing it, since much of the farm infrastructure is now in place in the new grain-producing regions. This could reduce the potential gains to the more efficient producers.

Carter undertook a case study to examine the potential effects of trade liberalization on Canada's agricultural trade with Japan. He found that Canada would gain considerably if Japanese agricultural trade barriers were removed. For example, the elimination of Japanese import duties on canola oil would increase the net revenue of Canadian crushers by 6.3 per cent a year and encourage more domestic processing in Canada. A recent study also estimates that Japan's food import bill would rise from $20 billion to $32 billion (in 1986 world prices) with the elimination of trade barriers.

Increasing protectionism

While Canada would benefit from trade liberalization in agriculture, protectionism in this sector has recently "gotten out of hand," Carter said. Japanese and European farmers receive the highest level of support on such products as rice, sugar, and dairy products. As for wheat, subsidies in the EEC were roughly four times those in Canada in 1987, while for barley they were about 10 times greater.

Export subsidy levels in the United States have increased recently under the U.S. Export Enhancement Program. The program provides export price subsidies that have enabled the United States to sell grain in export markets below the loan rate set under the 1985 U.S. Farm Bill. In some cases the subsidies under this program cover as much as 70 per cent of the variable costs of production. Originally the subsidy program was directed toward EEC customers only; it has since been expanded to include such countries as China and Russia. Carter said that subsidized grain sales to those countries have been especially harmful to Canadian farmers because those markets are so important to Canada. The program is damaging to exporting nations in general, because it results in lower world prices. "Clearly the importers are the large gainers," he said.

One of the obstacles to trade liberalization in agriculture is finding a way in which to identify and measure trade-distorting subsidies. So part of his research involved examining the use of "producer subsidy equivalents" (PSEs) to measure the rate of protection. A PSE is simply the percentage of the total value of production accounted for by trade-distorting subsidies. From such calculations, Carter discovered that although Canadian wheat farmers did not receive as much support as U.S. farmers, the difference was "not too substantial." He noted, however, that deficiency payments to Canadian farmers were introduced in response to U.S. policy actions.

Positive steps

Despite the growth of protectionism in agricultural trade, Canada "should not give up on the notion of trade liberalization," Carter said. He pointed to several positive steps in this regard. In fact, protectionism in agricultural trade has grown to such proportions that liberalization is finally beginning to receive serious attention by policy makers around the globe. Agriculture is on the bargaining table at the current negotiations under the General Agreement on Tariffs and Trade. The focus of the discussions will be on the policies of the developed countries. These nations have also agreed to reduce commodity price support to farmers. The United States has proposed that developed countries eliminate all subsidies that influence agricultural trade by the year 2000. The "Cairns Group" of 13 major small and medium-sized wheat- and rice-exporting countries (including Canada) has also called for liberalization of agricultural trade.

The changing farm

With the high cost of farming these days and the trend to larger commercial operations, many traditional family farms – once the cornerstone of Canadian agriculture – are in financial difficulty.

A Prairie farm that cost some $40,000 in 1961 could easily have cost $400,000 by 1981, making it increasingly difficult for anyone to get into farming. And if past trends continue, there will be fewer small farms in the years ahead and an increasing number of large corporate operations, according to economist Ludwig Auer of the Economic Council, who is deputy director of the Council's agriculture project. In his presentation, Auer outlined what has happened to farm incomes and costs over the past two decades, how farms have changed, and what Prairie agriculture could look like in the future.

Crop and livestock production on the Prairies has increased dramatically since the 1960s. As prices rose during the 1970s, Prairie farmers invested heavily, mostly in land and buildings. By 1985, farmers' cash operating expenses had more than quadrupled, with interest payments on loans accounting for about a fifth of the total. These interest payments are critical, Auer explained, because they cut into labour income (the income remaining after all other costs are deducted). By 1985, labour income was close to zero in all three Prairie provinces.



Prairie farmers would benefit from trade liberalization.

Employment and Immigration Canada

Financial stress

Between 1981 and 1985, Prairie crop prices fell some 20 per cent, leaving every fourth Prairie farmer in financial difficulty. Auer established four degrees of financial stress: nonviable (having no cash income after payment of cash expenditures); deteriorating (bordering on nonviable); vulnerable (when family income is not quite enough to meet living expenditures); and stable. The situation in Alberta was somewhat more favourable than in Saskatchewan and Manitoba, partly because of higher off-farm incomes in Alberta and more livestock production in that province.

The degree of financial stress varied among the major farm types. It was lower on grain and livestock farms and higher on mixed and specialty farms, Auer reported. The degree of indebtedness also affected the degree of financial stress. Young full-time farmers (below age 35) carried heavier debt loads, and nearly half of them were in financial difficulty. Elderly farmers (over age 64) experienced the least financial difficulty. Small marginal farmers were also in fairly good financial shape, probably because they didn't qualify for more loans during the boom period, Auer suggested. The impact of debt on the farm financial situation has been substantial, in fact. Had all farmers been debt-free, for instance, only 5 per cent would have been financially stressed.

Disastrous effect

Between 1985 and 1987, cattle prices increased and wheat prices dropped sharply, having a "disastrous effect" on the financial situation of grain farmers in particular, Auer continued. He estimated that the proportion of farmers in financial difficulty would have doubled had governments failed to take action at this point. For its part, the federal government responded with the Special Canadian Grains Program, which provides payments to farmers to help offset low grain prices. The program seems to have benefited those who needed the most help, according to Auer. Overall, it lowered the share of Prairie farmers in financial difficulty by roughly one-fifth (see chart).

At the same time, those farmers in the most serious financial difficulty were probably not good managers, Auer found. Their productivity performance was below average, irrespective of the age of the operator, farming region, or use of capital, labour, and material inputs. Targeting government transfers at those farmers could help them, but it could also blunt the competitive edge of Prairie agriculture.

One method of stabilizing grain-farm incomes is to encourage farmers to diversify into livestock production. But Auer noted that resource productivity on livestock farms is lower, on average, than it is on crop farms. Another suggestion is to have government subsidies tied to farm incomes rather than commodity prices. Auer also pointed out that an increasingly large portion of farm-family income comes from off-farm work and investments.

In the past, Canada has adjusted much more slowly than many European countries (as well as the United States) in terms of the shift away from agricultural employment. This is partly because European countries have traditionally had higher levels of employment in this sector, but also because it is difficult to compare Prairie with European agriculture. Auer said he expects adjustment in Prairie agriculture to continue as more farmers leave the industry in the years ahead, even as grain prices (wheat, in particular) increase.

If the past in any indication, the number of part-time and elderly farmers will increase in future, while there will be fewer full-time marginal farmers and fewer full-time commercial farm operations. At the same time, Auer projected that by the year 2000 the medium-sized commercial family farm will continue to dominate the scene, accounting for close to 60 per cent of all farms and more than 70 per cent of total farm output. The number of large corporate farms, many of them also family-owned, is expected to account for 3 per cent of all farms and 20 per cent of farm output.

Identifying the problems

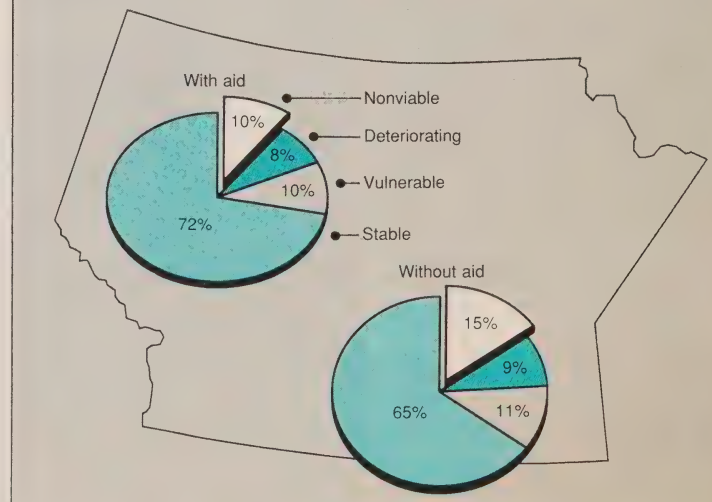
Why is Prairie agriculture in a crisis despite the massive government support provided under various programs?

One reason is that policy makers have failed to identify the fundamental problems in this sector, with the result that Canadian agricultural policy has in some ways contributed to the crisis in agriculture, according to Professor Murray Fulton and Professor Ken Rosaasen of the University of Saskatchewan.

The volatility of the export-oriented grain industry results in fluctuating grain prices and fluctuating farm incomes, as Prairie agriculture moves through its boom and bust cycles. A variety of policies and programs have been developed by the federal and provincial governments in an effort to stabilize the incomes of Prairie farmers and their communities. While such efforts have been reasonably effective at combatting the income problem, they have been almost ineffectual in alleviating the

How federal aid helped Prairie farmers

Impact of Special Canadian Grains Program on the financial situation of Prairie farms, 1987



massive debt loads faced by Prairie farmers. In the current downturn, the income from grain sales and government support programs is in many cases insufficient to service the huge debt in the farm sector. Farmers find themselves depleting their assets and sometimes looking for part-time or permanent work off the farm, in order to generate enough income to cover their living expenses. With a debt/equity ratio in the range of 1:2 to 1:3, Prairie agriculture can almost be considered bankrupt, the researchers said.

The research

Fulton and Rosaasen examined the policies adopted by governments in response to the crisis in Prairie agriculture and offered some suggestions for developing policies in the future. In their view, policy makers should give more emphasis to the debt problem. In addition, programs and policies must be examined in light of their implications for Canadian agriculture and what they prompt other countries to do, and in light of their impact on businesses affected by the health of Prairie agriculture.

In their examination of government involvement in the agricultural sector, the researchers concluded that many of the policies and programs outlive their usefulness, contribute to a new problem, or have unintended effects on other sectors. For example, the *Western Grain Stabilization Act* (which maintains the cash flow of western grain producers during periods of depressed prices or reduced sales) has been relatively effective at addressing the problem of fluctuating incomes; however, it has also increased feed grain prices in western Canada and subsequently reduced the viability of livestock production in that region. In that sense it discourages Prairie farmers from diversifying out of the grain-export trade.

Furthermore, government policies often have a destabilizing impact on Prairie agriculture. For example, subsidized interest rates and relaxed credit restrictions in the late 1970s and early 1980s contributed to escalating land prices by increasing the demand for land. Instead of making it easier for farmers to get started or to expand, the result was that land prices were simply bid up even higher. Hence government farm credit programs have tended to exacerbate the problem of fluctuating asset values. Overall, the researchers conclude that "Canada has a plethora of agricultural programs but not an agricultural policy." Too often these programs support yesterday's winners and fail to take advantage of tomorrow's opportunities.

The debt problem

Fulton and Rosaasen examined the debt problem in particular. They noted that the crisis in this regard is the result not only of current low grain prices but also of the boom period five to 10 years ago, when farmers began bidding up the price of land as they expanded operations or entered the industry. While the majority of farmers appear to be able to ride out the current devaluation of their asset values, a significant portion of them cannot. The question facing Prairie agriculture is who will pay – farmers, financial institutions, or governments? The researchers pointed to a number of options, including interest-rate reductions and equity financing. Should farmers and local financial institutions be left to cover most of the cost, the impact on rural communities could be quite severe, they said. If financial institutions take the biggest part of the loss, they may be less willing in the future to supply the credit needed for a capital-intensive industry like agriculture. If governments absorb a large portion of the losses, some of these short-run concerns will be mitigated, but at the expense of taxpayers and at the risk of encouraging future debt crises.

The researchers outlined a number of major policy approaches that might be considered in the future – supply management, the decoupling of government assistance (so that it is not tied to production of a particular commodity), the adoption of a Canadian version of the U.S. Farm Bill, and a modification of existing policies. While no one policy is perfect, they noted, each contains elements that have been, or will be, proposed.

In developing new agricultural policies, the researchers emphasized that it is imperative to take account of past lessons. In particular, the problems of debt and income must both be addressed. This will require two different types of policy initiatives, they pointed out, because the root causes of these problems are different. The role that Canada plays in the international market and its influence on the behaviour of other countries must be emphasized, since cooperation is the key to solving problems that are international in scope. Finally, there must be an attempt to streamline agricultural policy. The cost of many policies, each pulling or pushing in different directions, is enormous. In fact, many policies are introduced in order to correct the problems created by earlier policies. Such conflicts tend to ensure that only a few of the policy objectives are ever actually attained.

Government policies often have a destabilizing impact on Prairie agriculture.

Diversification of Prairie agriculture is one of the key elements to overcoming the crisis in this sector, according to a group of panelists who looked at the options in this regard.

Diversification could mean the production of various commodities whose prices are inversely related, so that farmers would be somewhat more protected against falling wheat prices, for example. It could also mean developing upstream and downstream activities in the input supply and processing industries, for instance. The panelists also suggested looking at the impact of irrigation on diversification and at such issues as transportation, economies of scale, and environmental concerns such as soil degradation.

Conference participants agreed that what is required from governments is consistent policy and possibly a national agricultural strategy. Some suggested that many of the problems in Prairie agriculture are partly the result of government policies that distort economic decisions. Others pointed to the growth of government subsidies and global protectionism as serious constraints to the future of Prairie agriculture.

One issue that highlighted much of the debate throughout the conference was whether or not Prairie agriculture would be viable in the years ahead. Conference Co-Chairman Andy Schmitz noted that Prairie agriculture is a boom-and-bust industry that will undoubtedly see its fortunes improve over the next decade. But the inherent instability of agriculture will require better management in the future. "We will always be on a knife's edge," he concluded.

Creating jobs in the private sector

During the late 1960s and early 1970s many western governments began looking for new ways to combat that period's soaring unemployment rates.

One such method was direct job creation. Two of the best-known strategies in this regard were public-service employment programs (to build infrastructure such as roads, for example) and wage or employment subsidies to the private sector. In recent years, the federal government has substantially increased its support for direct job-creation measures. Federal outlays in this respect rose from about $170 million in the 1975/76 fiscal year to an annual average of about $500 million between 1977 and 1986. Until recently, these funds were spent mainly on public-service employment programs. Lately, however, the government has been emphasizing private-sector initiatives like wage subsidies. How effective have these measures been?

To help answer that question, Council economist Surendra Gera undertook a detailed study of the Canadian Employment Tax Credit Program (ETCP) as part of his research on unemployment issues. The program was established in 1978 to stimulate additional private-sector employment, as well as to improve the employability of program participants, who were drawn mostly from the ranks of the hard-core unemployed and who had to be referred by a Canada Employment Centre.

Program details

Designed as a two-year program, the ETCP was extended for a third year and ended on March 31, 1981. The aim was to create about 50,000 jobs annually across Canada. To be eligible for tax credits, employers had to create jobs that constituted an addition to their work force. The jobs had to be full-time (at least 35 hours a week), had to pay at least the appropriate provincial minimum wage, and had to last for a minimum of three months. Credits could be paid for as long as nine months (later changed to 12) for each eligible worker. Employers benefiting from the ETCP could not be directly subsidized by any other government program.

The program was regionally targeted. Employers in the Atlantic provinces and Quebec's Gaspé Peninsula received the largest credits ($2 per person-hour of additional work created), while those elsewhere received either $1.75 or $1.50 per person-hour, depending upon local unemployment rates. Firms could "collect" their employment tax credits by deducting them from their federal income tax. If a firm's federal tax was less than the total credits earned in any one year, it could carry all or part of those credits forward, for up to a maximum of five years. The credit was neither transferable nor refundable.

In his study, Gera was primarily interested in three questions:

- Was the program economically efficient (i.e., did its net benefits exceed its net costs)?
- Did the program lead to a net increase in employment?
- Did the program improve participants' long-term employment prospects?

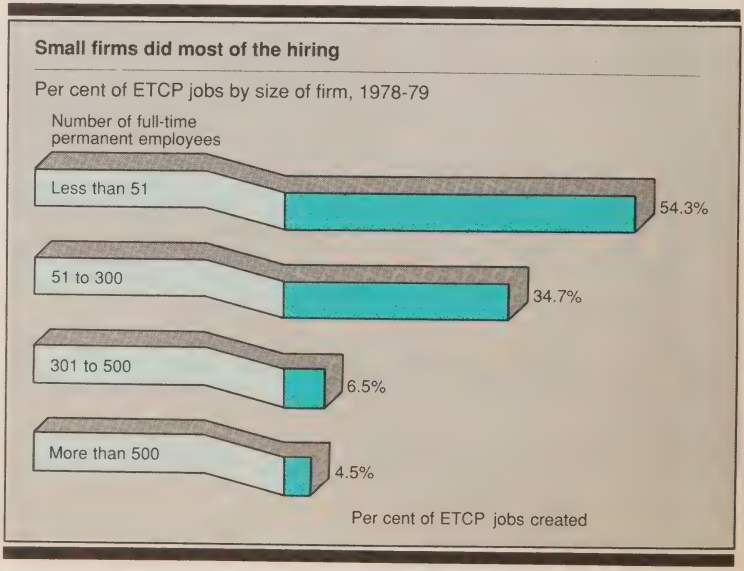
The experience

The great bulk of ETCP hiring was done by small and medium-sized firms (see chart). In addition, the vast majority of participating firms hired only a small number of workers; in fact, about two-thirds of them hired only one worker.

Almost half the firms doing the hiring were in the manufacturing sector, although that sector (as of 1979) employed only about 20 per cent of all Canadian workers. In contrast, the service industries, which employed 66 per cent of all Canadian workers but accounted for only 36 per cent of ETCP hirings, were somewhat underrepresented. Manual occupations, such as fabricating and assembly or processing and machining work, accounted for slightly more than half the additional jobs.

Regionally, about three-quarters of the 113,182 jobs created were either in Ontario or Quebec; another 11 per cent were in British Columbia. Despite the program's targeting of Atlantic Canada, that region did not benefit to any great extent; in all, the Atlantic provinces accounted for less than 7 per cent of the jobs created.

The typical program participant was young, male, unattached, and unemployed. Females accounted for only one-third of all participants, though they represented 45 per cent of Canadian unemployment at that time. Over half the group was under 25, and nearly three-quarters had no dependants. About half of them had been drawing unemployment insurance benefits just before joining,



while 75 per cent had drawn such benefits at some point during the previous 18 months.

Economic efficiency

Through a series of calculations, Gera determined that the ETCP was indeed economically efficient, both in Canada as a whole and in all the provinces. The program's major benefit was the value of its participants' output, as represented by their wages. Its major cost was the "social opportunity cost" (SOC) of those participants – the economic value of what they would have been doing had the program not existed. The SOC is a composite measure, made up of such things as the wages that workers might have earned without the program, as well as the value of their leisure time.

Gera's results show that the weekly SOC of program participants varied considerably – from $26.74 per week in Newfoundland to $93.50 per week in Alberta and $88.46 in British Columbia. There are a number of reasons for this large interprovincial variation. To begin with, participants would have been much more likely to find alternate work in the two western provinces than in Newfoundland. Second, wages tended to be higher in Alberta and British Columbia. Third, the estimated value of the leisure time that participants gave up by joining the program was much greater in the two western provinces because the demand for labour was far higher there.

The program was of greatest net benefit in high-unemployment provinces such as Newfoundland and New Brunswick, because the weekly SOC was lowest there. Thus Gera concludes that the program designers were correct in providing greater tax credits in the high-unemployment provinces.

Employment impact

Not all the jobs created under the ETCP were truly new jobs. Gera found that about 13 per cent of them merely displaced existing jobs and thus did not constitute net additions to total employment. Moreover, he estimates that about 67 per cent of the program's participants would have been hired even without the subsidy. These impacts were greatest (70 to 75 per cent) in Ontario and the Prairies, and lowest (49 per cent) in Newfoundland. In all, Gera found that only about 20 per cent of all ETCP jobs represented a net addition to employment. Again, this figure tended to be larger in high-unemployment provinces like Newfoundland (41 per cent) and smaller in wealthier provinces such as Ontario (14 per cent).

A more positive finding was that the net program cost of $9,400 for each person-year of employment was quite reasonable compared with the cost of creating the same employment through other means, such as public-service programs, income-tax cuts, or protective trade barriers.

Gera's evaluation of the ETCP is least positive on the question of the benefits received by program participants. He found that the program did not succeed in increasing participants' employment prospects; nor did it increase their average weekly wages. There was, however, a modest increase in the average duration of their completed employment spells. This increase was somewhat larger for women than for men.

The lack of improvement in employment prospects did not surprise Gera, however, given that most program participants had a long history of employment difficulties and came from the lower end of the wage spectrum, where there are few opportunities for obtaining higher earnings.

Mixed results

Overall, Gera views the results of the ETCP as being rather mixed. Nonetheless, he regards wage subsidy programs as job-creation devices that are reasonably promising. First, such programs are direct, visible, and flexible; and they tend to work quite quickly. Second, their private-sector focus makes them politically acceptable. Moreover, unlike certain other job-creation measures, wage subsidies do not appear to be inflationary. Existing evidence suggests that such subsidies can cut unemployment by 0.5 per cent without simultaneously increasing inflation.

Gera concludes that well-designed employment subsidy programs have an important role to play, particularly during periods of high unemployment. But he cautions that they are no panacea for the problems of the labour market. Such programs should complement, not replace, sound macroeconomic demand-management policies. Employment subsidy programs should also be kept simple, so as to reduce administrative costs, and should not be narrowly targeted at particular socioeconomic groups, he adds.

Creating Jobs in the Private Sector: Evidence from the Canadian Employment Tax Credit Program, by Surendra Gera (EC22-148/1988E; $8.95 in Canada, $10.75 elsewhere).



More than 110,000 jobs were created under ETCP.

Employment and Immigration Canada

Lessons in regional development

Council Chairman Judith Maxwell spoke recently on the subject of regional development at the Canadian Economic Climate Forum in Ottawa. Following is an edited version of that speech.

Socially and politically, the people who founded this country did so because they wanted to pursue a destiny separate from that of their U.S. cousins. Economically, the provinces came together as one nation because they saw benefits in unity. They believed Confederation would create an economic surplus; the sum of Canada would be more than that of its parts.

There was a fairly obvious social contract implied in all of this. The partners in Confederation expected not only a share of the harvest produced by unity but also a role in its cultivation. They expected a piece of the economic action – the industrial growth, the jobs, the growth of local communities, and so on.

The challenge of fulfilling that contract has been part of our history from the start; but we've met it only partially. While the track record is good on the distribution side, we haven't been very successful in sharing economic development itself. I want to argue that we need to shift gears on regional policy and also that we need to find some new levers to get economic development established more strongly in the poorer provinces. The Council will be making a major statement on the issue late this year.

Public expenditures

Governments are engaged both in the redistribution of income and in economic development, in three main ways (see chart): transfers to individual Canadians to support their current living standards; transfers to businesses and communities to promote economic development in the private sector; and direct spending by governments (on roads, airports, and other infrastructure, for example). There is a fourth category not included here (expenditures on education and health care, for example).

While all of these approaches have their place, there is reason to worry that transfer payments have become a substitute for successful economic development. In Newfoundland, for example, transfers to persons accounted for 29 per cent of total personal income in 1986. This compares with 11 per cent in Ontario. Year after year, we are paying out huge sums to support living standards. We are building up a dependency on government cheques but failing to build up the capacity to earn income.

Over the years the Economic Council has contributed to both research and advice to the regional development debate. In 1977 we published *Living Together*. In that study, the Council identified differences in productivity levels as a critical factor in explaining regional disparities. The Council recommended that both federal and provincial governments make sustained efforts to raise productivity levels in the lower-income regions. We said that certain factors were crucial, including education, use of best-practice technology, management training, and efficient location of important support services.

Greater efficiency

Similar findings emerged from the study carried out by the Council in 1980 on Newfoundland's economic problems. The Council noted, for example, that greater efficiency in the local sector would lead to higher real incomes by reducing local prices and by allowing for higher wages. That would enable consumers to buy more locally produced goods and services. Lower costs would make it feasible to produce locally some of the goods and services that are currently being imported. Finally, greater efficiency in the local economy would encourage existing export industries to make greater use of local goods and services. In other words, a virtuous cycle would replace a vicious cycle.

The Council offered a long series of recommendations aimed at narrowing the productivity gap between Newfoundland and central Canada. Special emphasis was placed on the training of both managers and workers, and on more efficient infrastructure. We found, for example, that success was more likely when development was cultivated in small and medium-sized communities that had good transportation links to the outports and also to major ports.

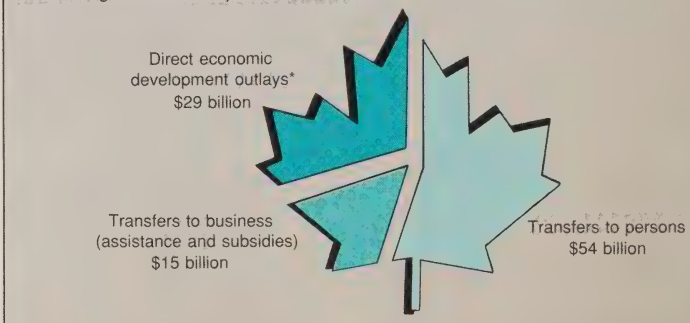
In short, the Economic Council has found that Canada's disadvantaged regions tend not to be using their local resources in the most efficient way. In that sense, they are not living up to their potential.

Location grants

Government programs have been consistent with at least part of these findings. Large sums of money have been invested in infrastructure and in education and training over the past 20 years. And considerable effort and money have

How Ottawa helps combat regional disparities

Federal government expenditures, 1984



*Includes resource conservation, transportation and communications, and regional planning.

been committed to attracting industrial plants into the regions. These location grants attract most of the headlines, but they are not by any means the main source of success.

The concept of "location grants" assumes that there are large industrial plants that are "footloose" – they are willing to locate in a depressed region provided they are offered the right package of incentives. Some plants, enticed in this way, have survived and prospered, providing good jobs for local people.

But enthusiasm for location grants has cooled. Many footloose plants have turned out to be uneconomic, not necessarily because of their location but because of such shortcomings as faulty market studies or weak management, for example. In other cases, location grants haven't fit in with local economic realities. The strategy is geared to large plants at a time when the main driving force for job creation is small business. Finally, location grants or direct subsidies to firms are highly exposed to countervailing challenge under U.S. trade law. Indeed, there is a growing tendency in the 1980s for firms facing import competition to charge their competitors with unfair trade.

GATT code

The Canada-U.S. Free-Trade Agreement requires both countries to abide by the subsidies code under the General Agreement on Tariffs and Trade (GATT). While the code does not discriminate against programs or policies that aim solely to redistribute income or jobs within a country, it is hostile to any grant or subsidy that is put in place specifically to influence trade or trade-related investment patterns. In the Council's view, the GATT code could, if properly implemented, exert a healthy influence on the design of regional policy in Canada. The trade agreement should also act positively in some cases on the way that U.S. institutions have interpreted U.S. trade law. Binding arbitration by the bi-national panel should put pressure on both countries to live by the GATT code.

The trade agreement will probably force Canada to make clearer distinctions between programs intended to redistribute income and those which redistribute economic activity. In effect, it will be more difficult for Canada to justify grants or subsidies targeted at specific firms to influence their location choices. I do not regard this as a hardship. We economists have been telling governments for years that these grants, subsidies, and tax incentives do not have a very high social payoff. In our recent Statement, *Managing Adjustment*, for instance, we pointed out that modernization grants, intended to make existing plants more competitive, added little or no incremental investment.

Specific problems

Research done here and in the United States points out that location incentives boil down to an "airborne economic operation" – an attempt to parachute in, in one neat package, a whole combination of inputs (ideas, management skills, financial capital, and so on). But parachutes are not what we need.

First, location grants automatically define the local problem as one that can only be solved from outside. By making this idea central, the location-grant approach downgrades, and may even inhibit, local initiatives unless the new plant is very intimately integrated into the community.

Second, typically it is not necessary for a community to import ideas, management skills, and financial capital in one package. In fact, it is usually both possible and better to unbundle these three ingredients and to foster their formation within the community. In all cases, outside resources are put to best use when they are directed by, or responsive to, local inputs of ideas, people, and capital. The resulting activity may be small-scale, but it can generate major payoffs in earned income and in mobilizing local resources.

The role of governments

As a result, we should expect to see an important change in the role of governments. While they should not dissociate themselves from regional and community development policy, they may have to become less directive in their approach, and they will have to design programs that bank on local talent and strength. Principally, they need to find new levers for development – levers that place more emphasis on spawning growth within the community.

For the past year the Economic Council has been engaged in a study that examines regional development from a bottom-up perspective (see *Au Courant*, vol. 8, no. 1). Through a number of case studies we are looking closely and in detail at strategies used by a wide array of different communities to build on local resources. Out of this study we hope to provide some guidelines for those who design regional-development policy. We know that the right strategy for regional development will have to meet several challenges. It must promote both efficiency and equity. It must mobilize the social and economic potential within communities. It must define new roles for governments that reconcile their desire to be involved and their need for accountability with the need to play a supporting role to community leadership. Finally, it must bring to Canada's regions not just a skim-off from the total national economic gains but a share in development itself. The goal, in short, remains what it has always been – fulfilment of the social contract of Confederation.



Grants to entice big business to smaller regions don't always work.

Employment and Immigration Canada

S·P·E·A·K·I·N·G · O·U·T

Canada is experiencing a rapid shift from a resource- and goods-producing economy to a service-based one.

That shift is causing major alterations in the patterns of employment, in the types of jobs being created, in the skills required by workers to fulfil those jobs, and even in the way in which industrial relations is conducted in Canada. The Economic Council is studying the impact of this transformation in a new project entitled "Employment and the Service Economy." To find out more about it, *Au Courant* spoke with project director Gordon Betcherman.

Au Courant: *What was the original motivation for undertaking this project?*

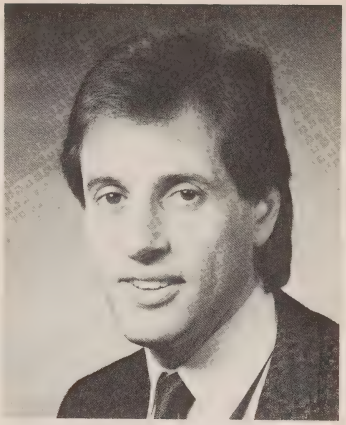
Betcherman: The Council has been doing research in the area of labour markets for some time. Most recently we studied the impacts of technological change on the labour market. As we concluded that research, we became interested in looking at some other aspects of how the labour market is changing. One of the more fundamental changes that has been taking place over the years is the shift from a goods-producing to a service-sector economy.

Au Courant: *What do you see as the primary aim of the project?*

Betcherman: Our primary goal is to look at the Canadian labour market to see how the transformation to a service economy has affected various aspects of employment. Ultimately, we want to be able to see whether or not public policy in this area has kept pace with the changing world.

Au Courant: *What will the project examine in particular?*

Betcherman: One of the most important issues, as I've said, involves an examination of the whole range of labour market programs in Canada. We want to find out, for instance, whether training programs are being provided in the types of jobs and skills that are growing in demand as a result of the growth in the service economy. We shall be looking at labour adjustment policies in general, because of the large



Gordon Betcherman

amount of displacement that is taking place as employment falls off in the goods-producing industries and as new job opportunities are created largely in the service sector. These displaced workers require assistance to make the adjustment easier. Are present policies effective and, if not, what changes are required?

We shall also be investigating the potential for maintaining high employment growth in an economy that is becoming increasingly service-oriented. For example, do we need a strong goods-producing sector in order to feed growth in the service industries? This has become a controversial question, not only in Canada but in virtually all industrialized nations. The answer has significant implications for industrial policy.

Another important consideration is the interrelationship between demography and the demand for labour in the service sector. Traditionally, many service-sector jobs, particularly entry-level jobs, have been filled by young people and by women returning to the labour market. In the future, demographic trends indicate that there are going to be fewer and fewer young people, while, at the same time, the rapid increase in female participation in the labour force appears to be slowing down. If these two traditional sources of service-sector workers are contracting, who is going to fill these jobs? We shall also be looking at the role of women in this segment of the labour market.

The shift to a service-sector economy also has implications for industrial relations, and collective bargaining especially. Unlike the manufacturing sector, where roughly half the workers are represented by unions and engage in collective bargaining, the service sector shows relatively low rates of collective bargaining, particularly when you look at the non-government service sector. Since collective bargaining has historically been very important to labour relations in Canada, we want to look at why it has had trouble taking root in the service sector and at how the traditional model might be adapted to service industries.

Au Courant: *How important is the service sector? How substantial has the growth in this sector been?*

Betcherman: The growth in service-sector employment in proportion to the rest of the economy has been truly remarkable. For instance, right after the Second World War about 40 per cent of the Canadian labour market was employed in service industries. Today this sector accounts for more than 70 per cent of employment. That kind of numerical shift is really quite striking.

Au Courant: *Has growth in the service sector been at the expense of growth in other sectors?*

Betcherman: In terms of employment, both the primary and manufacturing sectors have been declining while the service sector has been expanding. However, the picture is slightly different if you look at it from the point of view of production. The manufacturing sector, for example, has not declined in terms of output. Gains in productivity have been an important factor in this regard.

Au Courant: *How will the research be conducted?*

Betcherman: It will involve using a range of statistical techniques. One example is "input/ouput analysis," which we shall be using to examine the linkages between various economic sectors. This technique will enable us to identify how the output of one industry

affects another, for example. As I mentioned earlier, this is important in considering the question of how much service-sector growth is driven by a strong goods-producing sector.

> ***Over the years there has been a fundamental shift from a goods-producing to a service-sector economy.***

The 1986 census data will be invaluable to us. It will bring us up to date on various developments in the labour market, including the number of people working in different occupations. We shall also use the census data to look at such things as the distribution of earnings, to see the effect of shifts in the labour market. This will enable us to examine the contention that many of the newly created service-sector jobs are either very high- or low-paying.

We shall also be using an econometric model developed at Trent University to help us understand the growth of the service sector. Essentially we are trying to gather a wide range of statistical data and to employ a variety of techniques to cast light on many unanswered questions.

Finally, we hope to do some qualitative analysis. By that I mean looking at such things as the quality of employment, to find out whether or not the new service-sector jobs are the kind that Canadians find desirable. We want to look at the skill levels required for these jobs and whether or not the jobs offer employment stability. Statistical analysis can only provide so much information in this regard. These are issues that require an element of qualitative analysis.

Au Courant: *How will you investigate these qualitative issues?*

Betcherman: One way is to undertake a series of case studies of various occupations. This would enable us to identify the actual skills required for these occupations and the type of work that is actually done on the job. We shall also be conducting interviews with people in the field and with members of occupational associations, in order to get a feel for what's happening in various occupations and, most importantly, to determine whether or not Canada is developing people in these fields to fill the expected demand in the future.

The quality of Canada's labour force is critical to a successful service economy. Many service industries are operating in increasingly competitive markets, sometimes on an international scale – in financial and business services, for example, and in communications. Therefore it's essential that Canada have the education and training infrastructure to sustain and develop a first-class labour force.

Au Courant: *Is the Canadian situation comparable to what's happening in other countries?*

Betcherman: That's something we intend to examine as well. We're hoping to compare the Canadian experience with that of other developed countries – including the United States and Japan, and perhaps West Germany. The shift to a service economy is certainly not a phenomenon that is restricted to Canada. However, the pace of the shift and the types of jobs that are being created appear to be somewhat different in some countries. We expect to examine how the shift to the service economy has differed among countries and to identify the key variables that drive these differences.

Au Courant: *What will the project produce?*

Betcherman: The Council plans to publish a policy Statement in the fall of 1989, based on the results of our research. The Statement will be accompanied by a research report detailing the findings on which the Council bases its policy recommendations. As well, we expect to publish a number of background studies throughout the duration of the project and following the publication of the Council Statement.



Service sector jobs are increasingly important.

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Economic Council of Canada

Volume 9, No. 2, 1988

The Council's Annual Review of the economy



- Multinationals and free trade
- A new project on unemployment issues

PUBLICATIONS

Twenty-Fifth Annual Review

Back to Basics (EC21-1/1988E; $8.95 in Canada, $10.75 elsewhere).

The Twenty-Fifth Annual Review sets out Canada's medium-term economic prospects against a backdrop of such long-run trends as the global stagnation of commodity prices, the growing fragmentation of world economic power, and the shift from a resource-based to a service economy. The Council presents a new set of targets for economic performance for the next five years, mindful of the fact that, after six years of strong growth, the economy is now entering a danger zone in which accelerating inflation and recession could both occur. The Review also focuses on the growing disparities in regional unemployment rates, resulting in part from differences between the regions in the way that the industrial structure is changing. These structural shifts are altering the nature of work and causing a mismatching of people and jobs. The Review proposes two priorities for economic policy: enhancing competitiveness; and strengthening human resources.

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Volume 9, No. 2, 1988

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FEATURE

Back to Basics



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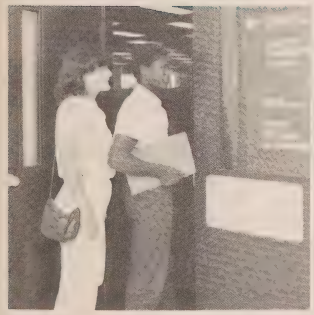
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Au Courant *est également disponible en français.*

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its staff and others. The findings of these reports are the personal responsibility of the authors. Neither the original publication of these studies and papers, nor their condensation for the purposes of this magazine, should be taken to imply endorsement of their conclusions and recommendations by the members of the Economic Council.

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Editor: Jonathan Massey-Smith

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Back to Basics

Over the next five years, Canada needs to show more fiscal restraint, enhance its competitiveness, and give greater priority to developing its human resources, the Economic Council says in its Twenty-Fifth Annual Review of the economy.

Attention to these three priorities is crucial in order for Canada to prosper in an increasingly complex world marketplace. Without strong fiscal restraint by governments, significant economic hardship may be inflicted on the economy in general and on regions outside central Canada in particular, the Council warns. To increase its competitiveness, Canada should, among other things, continue to pursue more open trade with other countries, develop and use more technology, and improve its education system. All players in the economy must work to improve the quality and adaptability of the labour force, which will be so important to productivity growth and competitiveness in the years ahead. These three priorities will remain important, not only in the medium term, the Council maintains, but well into the next century.

The Council looks ahead in this year's Annual Review to the year 2000. It also takes stock of Canada's economic performance over the past 25 years.



Looking back

On looking back, Canada has much to be proud of, the Council says. Today, Canada is a more productive nation. More Canadians, including many more women, are in the labour force. Output per worker is nearly half again as high as it was 25 years ago, and partly as a result, Canada is a richer nation: real income per capita has more than doubled since 1963.

For most Canadians, the quality of life has also improved in many respects. They enjoy a rich cultural life, and people generally are healthier and have access to a wider range of educational programs and institutions.

But there have been setbacks. Several recessions have interrupted economic growth, the worst of them occurring in 1981-82. Since the mid-1960s, unemployment has persistently trended upward, and it remains unacceptably high in many parts of the country. Real wages for some workers have been declining for more than a decade, and many Canadians still live in poverty. Governments are burdened by excessive debt loads. Environmental degradation has become a major concern.

Reasons for caution

Since 1982, Canada has made some progress in restoring productivity growth, competitiveness, and price stability. But Canadians will have to be cautious over the next few years for at least two reasons. First, any sustained period of growth, such as that which has occurred since 1982, tends to lead to imbalances in financial markets and to bottlenecks in production. This raises two threats: that of either a recession or a burst of inflation. Second, storm clouds remain on the international horizon – notably the problems stemming from the huge U.S. trade and budget deficits, and the faltering economies of many heavily indebted developing countries.

Over the longer term, the Council identifies three trends in particular that will continue to have a bearing on future progress. First, commodity prices in relation to the price of manufactured goods are generally unlikely to boom over the next few years. While this is a source of some economic stability for the world economy, countries or regions (like western Canada) will find their economic growth constrained. Second, the shift in the industrial structure from goods-producing to service industries demands new skills in the work force. Third, the fragmentation of economic power, as the United States loses its dominant leadership role, adds to economic uncertainty and complicates international decision making.

The research

With these trends in mind, the Council undertakes a detailed examination of Canada's medium-term prospects. It highlights some of the tough trade-offs between policy objectives, with special emphasis on the tensions between unemployment and inflation. In particular, it examines why high unemployment persists in some regions of Canada. Drawing on its research project "Visions of Canada in the Year 2000," the Council also looks at the long-run trends in global politics, economics, population, ecology, and technology. Finally, the Council sets out priorities for economic policy and new targets for Canada's medium-term performance. *Au Courant* summarizes this research on the following pages.

Outlook for the economy

The charts on the next two pages indicate the outlook for six key economic indicators over the 1988-92 period. In each case, the basic projection is compared with three alternatives – a high-growth, a low-growth and a policy-mix case – based on different assumptions about international developments and the strength of consumer and business confidence in Canada.

Growth

According to this year's base case, real economic growth in Canada over the 1988-92 period is projected to average 3 per cent annually. In 1988 it is expected to reach 3.8 per cent. But a combination of slower growth in exports to the United States and a tail-off in the domestic investment cycle, particularly in the housing sector, will depress annual growth rates to the 2.2 to 2.6 per cent range in 1989 and 1990.

The deficit

During the 1988-92 period, the federal deficit as a proportion of gross domestic product (GDP) is expected to average about 4 per cent. Because of the slow growth in 1989-90, however, the Council sees little likelihood of a quick improvement in the federal deficit, despite assuming a continuation of rigorous spending restraint.

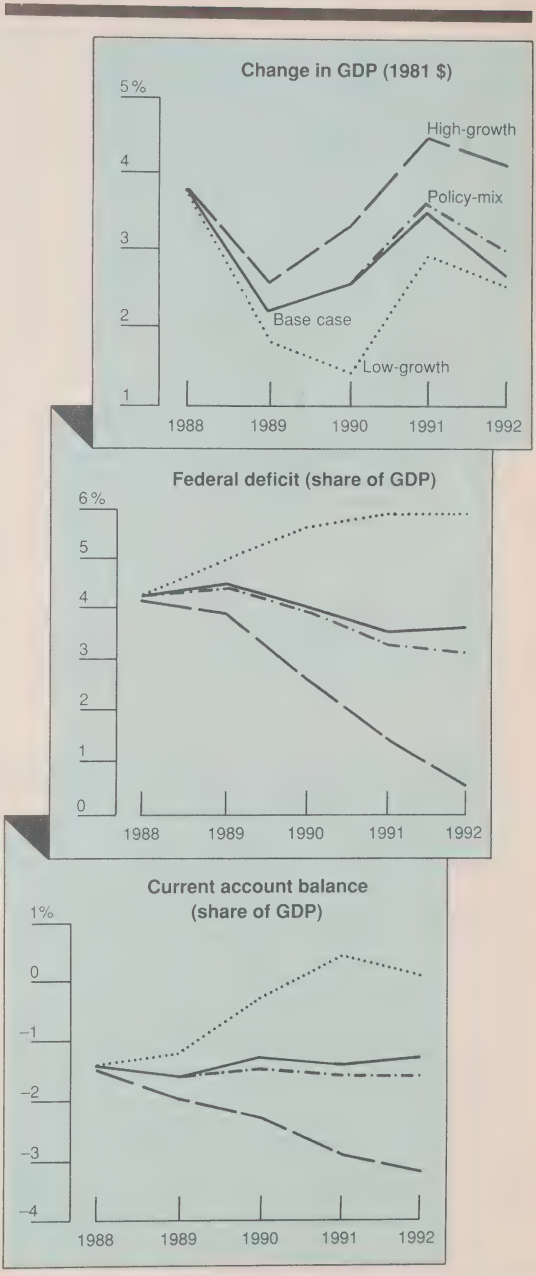
Balance of payments

Canada's balance of international payments on the current account will remain in deficit during the 1988-92 period, averaging just under 1.5 per cent of GDP. This is due in part, the Council says, to the average real growth rate of about 3 per cent over the period, which will increase demand for imported goods. At the same time, the growth slowdown projected for the United States will inhibit Canadian exports early in the period.

Inflation

The most controversial issue in the medium-term outlook relates to the outlook for inflation, the Council says. It points to a number of unsettling indicators, including a renewed upswing in commodity prices (other than those for food and oil); some overheating in southern Ontario, particularly in the housing market; some evidence of labour shortages; an increase in the ratio of consumer debt to disposable income, now above its 1982 peak, and annual growth in the money supply, which until recently averaged 10 per cent.

In all, the upward pressure on prices and costs is greater than it has been since 1981, but the Council expects that inflation pressures will be contained. The rate of increase in consumer prices is expected to peak at just over 5 per cent in 1989, for three reasons. Monetary policy will lean against any upswing in prices and costs; relatively abundant supplies will restrain oil and grain prices; and many wage and price decisions will be influenced by the painful lessons of the 1981-82 recession.



Labour productivity

Productivity growth over the past six years has diminished the imbalance between wages and productivity that occurred in the 1970s, when real wages accelerated but productivity growth stagnated. That means the fundamentals are in place to permit a rise in real wages in concert with future gains in productivity, the Council says. But growth in labour productivity is expected to average less than 1 per cent over the 1988-92 period. Some strengthening is expected to follow the growth slowdown of 1989-90, but, generally, the outlook for productivity is not promising, the Council adds.

Unemployment

The unemployment rate is projected to average 7.6 per cent between 1988 and 1992. The slower-growth period in 1989-90 is expected to stall the downward trend in unemployment for a time, but when economic growth picks up again in 1991-92, the rate will drop to about 7 per cent.

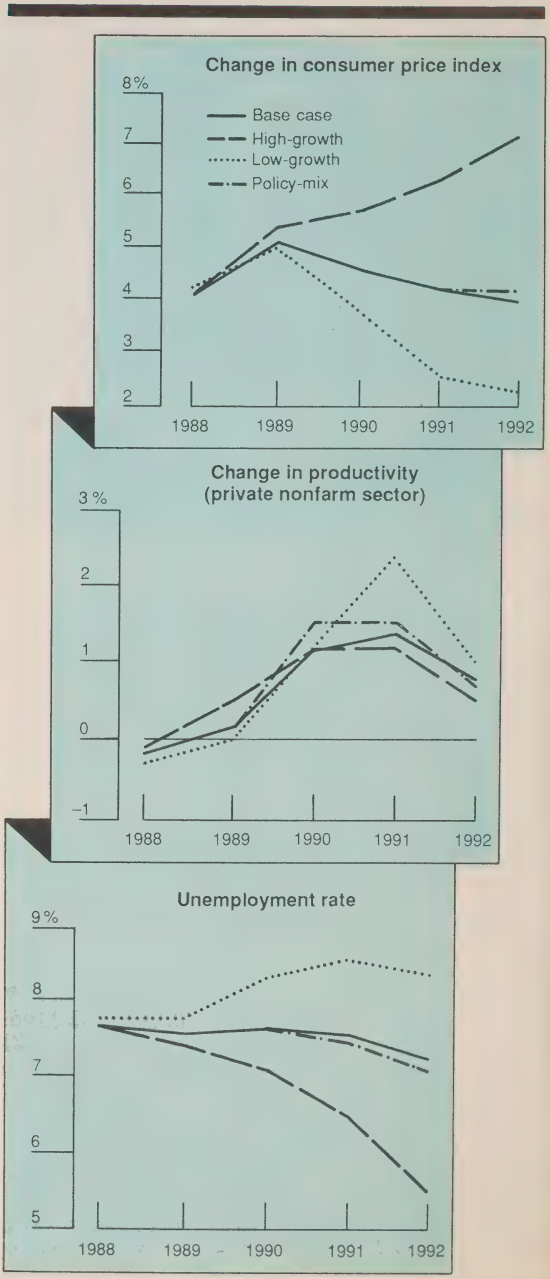
It has taken six years of economic expansion to get Canada's unemployment rate down from more than 12 per cent to slightly below 8 per cent. During the same period, the rate of inflation subsided from over 12 per cent to about 4 per cent. This represents substantial progress on both fronts, but the Council's analysis shows that it will be much more difficult to push the unemployment rate further down without, at the same time, causing upward pressure on prices.

Council research suggests that some sectors and regions of the economy are experiencing labour shortages despite relatively high unemployment rates because of a mismatch between workers' skills and employers' needs. Unemployment of this type is termed structural because it reflects the unemployment associated with the structural characteristics of the labour market, regardless of the pace of economic activity. If government is to reduce unemployment rates, it must put in place job training and labour-market programs aimed at increasing the supply of workers whose skills match those sought by employers. The challenge, in the Council's view, is to do so while keeping the economy growing at a moderate rate.

The Council's examination of structural unemployment indicates that it has been declining since 1982 and is expected to remain in the range between 7 and 8 per cent during the 1988-92 period. Since the actual rate is now in that range, the Council says that in the short run "it would be dangerous to try to reduce unemployment by stimulating economic growth" because the immediate outcome would be much more inflation, with relatively little reduction in unemployment.

Finally, the Council notes the dilemma facing policy makers: the economy is moving closer to the point where inflation pressures could become serious; high rates of unemployment persist and regional disparities have widened, even though the economy is operating at close to capacity; and the high levels of government debt and foreign borrowing leave Canada vulnerable to a slowdown and tie the government's hands in fighting unemployment.

Given these circumstances, the Council sees two priorities for the medium term. Governments must reduce their deficits, and they must focus more attention on the problem of labour-market mismatching.



Labour markets in transition

Over the past two decades the Canadian labour market has drifted into a situation where more unemployment and more job vacancies coexist because of an increase in the degree of labour-force mismatching (which occurs when the characteristics of unemployed workers do not match the requirements of the new jobs that are being created). While many factors can contribute to such unemployment, the most important for Canada in recent periods has been the industrial restructuring of the economy in response to changes in demand and technology.

Canada needs better-focused training programs if it is to speed up the decline in stubborn rates of unemployment, the Council finds.

Some job vacancies and unemployment will exist in a healthy labour market as individuals search among the available vacancies for the best fit of their skills and wage expectations, the Council explains. As the accompanying chart illustrates, however, this "natural" or structural unemployment rose dramatically in the early 1980s.

Commodity shocks

The shock of high oil prices in the 1970s had a major impact on demand in the economy. Overnight, the shift in demand from energy-guzzling to energy-efficient products caused significant growth for some firms and industries, while others saw the demand for their products evaporate. This situation was exacerbated by the second oil shock of 1979 and the events that followed, including high interest rates, the 1981-82 recession, and the drop in other commodity prices.

Many firms responded by rationalizing their operations. Overall, the movement from a goods-producing to a service-based system quickened. This was reflected in an acceleration of the rate at which jobs disappeared, as well as in a radical shift in the nature of the new jobs being offered. As a result, some workers in the goods industries have had trouble adjusting.

That interpretation of the increase in structural unemployment is supported by such indicators as the increase in long-term unemployment (defined here as that lasting 53 weeks or more). Such lengthy unemployment indicates a serious failure on the part of labour markets to match the unemployed with job vacancies.

Regional restructuring

Much of the increased disparity in regional unemployment rates is due to the variation among provinces in the pace and timing of the shift of employment from goods-producing to service industries, the Council finds. Sharp increases in structural unemployment occurred in the resource-based regions, with the Prairies and British Columbia experiencing the largest relative increases.

Finally, although recognizing its important social role, the Council also notes that the provision of unemployment insurance benefits has added to structural unemployment by affecting the willingness of individuals to work and the hiring decisions of firms. The contribution of unemployment insurance to provincial unemployment rates is largest in those provinces where regionally extended benefits are the most generous.

Service-sector growth

While the goods sector has been going through this transformation, most of the new employment that has been created is in the service sector. Seven out of 10 workers in Canada are now employed in this sector. Much of the growth in service-sector employment has occurred in business services (such as computing or engineering services) and in personal services (barbers or dry cleaners, for example), where the skill requirements tend to be very different from those in mining, manufacturing, and construction.

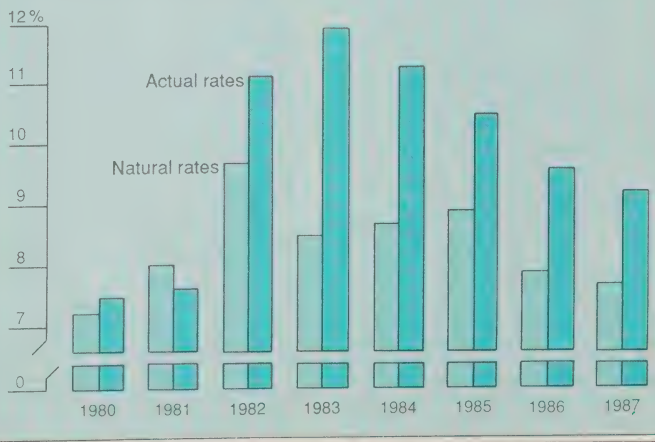
Skill requirements

A significant component of service-sector employment is likely to be in the low-paid and low-skill segment, the Council finds. But it points out that high proportions of these jobs are filled by young people and women. With the lower growth rates in female labour-force participation and the aging working population expected in the future, employers will be forced to upgrade the quality of these jobs, to recruit more older workers, or to press for increased immigration.

Overall, in order to attack the problem of labour-force mismatching at its roots, Canada will have to focus on programs and policies that help workers move from one industry or occupation to another.

The unemployment trends in the 1980s

Natural and actual rates of unemployment, Canada



A window on the longer term

Canada will face quite different challenges in the year 2000, but the economic policy priorities at the turn of the century will probably be remarkably similar to those of today.

In its Visions of Canada in the Year 2000 research project, the Council is looking ahead to the next millennium to determine the issues with which Canada will have to deal.

What has already become evident and will be increasingly important in the years ahead, the Council reports, are the growing linkages between national economies, the environment, and other global systems.

In the area of the environment, where problems often transcend national borders and threaten to impair future economic growth, this means that governments, acting alone, are unable to solve the problems. Without new, more cooperative approaches to reducing environmental degradation, the situation "could easily become chaotic," the Council warns.

The world economy

In the emerging world economy, the Council identifies five trends that will influence economic policy making in the years ahead. First, the economic gap between the industrial leaders and some of the successful developing countries will continue to narrow, primarily because of the rapid diffusion of knowledge and technology.

Second, while some Third World countries will fare well, those whose educational standards do not enable the people to make effective use of new technology or those in which there is a lack of either political stability or worker discipline are unlikely to break out of the pattern of poverty.

Third, the number of centres of substantial economic power is likely to grow over the next quarter-century. China, India, Brazil, and possibly (in light of recent political events) the Soviet Union and eastern Europe, are among those countries with the potential to become major economic powers, the Council says.

Fourth, economic convergence and rising living standards will make countries increasingly interdependent. That is already reflected in the pace of expansion of world trade, which has far exceeded the rate of growth of world output, the Council notes.

Finally, global markets for services are emerging. This extends international competition into activities that had been sheltered in the past – including telecommunications; and financial, engineering, management, and other consulting services. If the full benefits from these "tradable" services are to be obtained, the international community will have to work to reduce or abolish trade barriers in this area.

International governance

The complexity and unpredictability of global developments create a need for increased international cooperation; coordination; and, in some cases, harmonization of policies and practices.

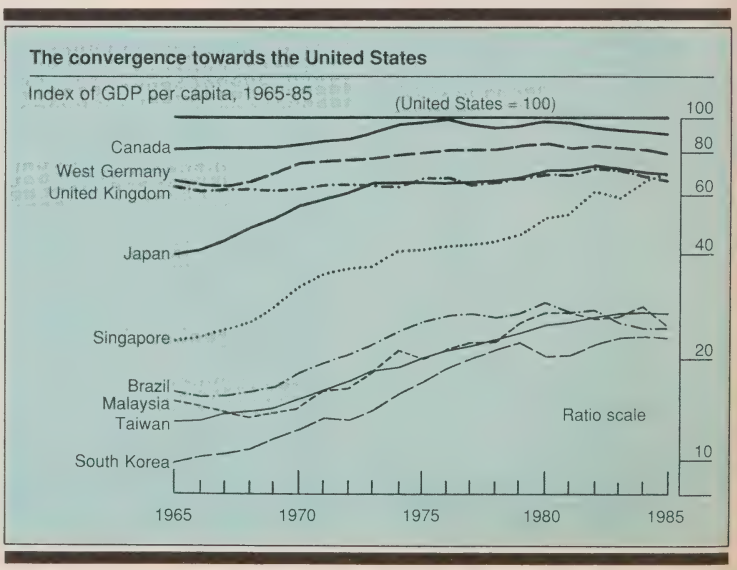
In the Council's view, existing international institutions – the World Bank, the International Monetary Fund, and the General Agreement on Tariffs and Trade (GATT) – lack the mandate and resources to deal with many of the problems that transcend national boundaries. This is because the situations that these institutions were originally intended to manage have changed. Therefore, either the institutions will have to be strengthened or new ones established, the Council says.

Options for Canada

As international competition grows, Canada will increasingly be forced to focus its production activities on goods and services that are more knowledge-intensive and that embody greater value-added; low-cost producers will usually be found in the less-developed countries.

Given this context, there will be two related priorities for Canada. First, it must enhance its competitiveness in the international marketplace. Governments can contribute to that goal by helping to shape the rules of world trade and to open markets through trade negotiations. But it is industry that must be competitive.

Second, Canada must give greater priority to developing its human resources. In basic education, one key issue is curriculum – teaching the basic communication skills and the stock of knowledge needed to function in society, as well as the ability to learn, which will also be a key skill in vocational education. The private sector will need to regard training as an investment, and training will have to be seen as a continuous process, not as an occasional, one-shot event.



Priorities, targets, and objectives

Canada should get back to basics, with a fundamental improvement in many of the policies needed to help make it competitive in the years ahead.

The Council stresses the need for wise policy, not only out of a concern for competitiveness but also because of the evolution of an increasingly complex and fragmented world in the next few decades. Its preliminary look at longer-run issues suggests new challenges for Canada's social and political institutions – in particular, the growing international dimension to decision making, with far more complicated linkages between world economic, political, environmental, and demographic systems. Canada will be in a much better position to prosper in this environment if it has "low levels of government debt, strong productivity growth, low unemployment, and a higher-quality education system," the Council concludes.

In light of recent economic developments, the Council has reassessed its targets for Canada's economic performance over the medium term (see box). While some targets remain unchanged, others are revised to reflect a shift in emphasis. The Council believes that annual employment growth should be in the range of 1.5 to 2 per cent. A more desirable target for the unemployment rate over the medium term lies in the 5 to 7 per cent range. The inflation target must be reduced to 4 per cent or less. And the federal deficit should be cut to no more than 2.5 per cent of gross domestic product by 1992 – a significant reduction from the current 4.3 per cent.

Policy responses

The Council's base-case projections for 1988-92 suggest that Canada will fall short on several of these targets unless there are three important shifts in policy priorities. The first is to shift the medium-term policy mix, putting more restraint into fiscal policy and allowing monetary policy to be more "accommodating," it says. The Council explains that because of the government's weak fiscal position, the burden of combatting any threat of accelerating inflation would fall onto monetary restraint, through higher interest rates. That would slow investment and consequently weaken productivity and competitiveness. Therefore the undue reliance on monetary restraint has "adverse implications for the medium-term performance of the economy," it says.

The second priority is to focus far more attention on enhancing competitiveness through such levers as trade policy, technology, and education.

Monitor progress

Canada's record of developing and adopting new technology has been weak in comparison with that of its major trading partners, the Council notes. It urges the federal government to undertake a regular, ongoing survey to monitor technological change as a means of providing better standards and benchmarks against which to judge Canada's technological progress.

Furthermore, it recommends that firms, working through industry associations, develop a variety of productivity measures to enable companies and industries to compare their performance with that of their competitors, both in Canada and elsewhere. Much better productivity indicators are needed for the service sector in particular. The Council supports current efforts in this area on the parts of some firms and industry associations but strongly urges others to follow suit.

On education, the Council notes that whatever Canada does in the medium term to upgrade the quality and adaptability of its labour force "will have a big pay-off . . . down the road."

Improvements in education and training also fall under the Council's third policy priority: to strengthen human-resource development.

Labour-market programs

In the Council's view, the main objectives of the federal programs – the focus on the individual and the effort to decentralize decision making on the allocation of funds – are appropriate. But it also endorses the recommendation that structural reforms be undertaken to give Local Advisory Councils even more input to decision making (as well as making these groups smaller and more collegial). The government should also reassess its allocation of funds within the Canadian Jobs Strategy to place greater emphasis on training to reduce structural unemployment.

More generally, the Council sees a growing need for customized courses to meet the needs of local employers. Many colleges and technical schools have resisted this change, however. What is required is more coordination among educational bodies, industry, unions, and governments. Finally, the design of training programs should not presume that older workers cannot be retrained, the Council stresses.

Industry action

Industry has much to gain from a highly qualified and well-motivated labour force. It must take responsibility for effective training, job design, work organization, and compensation systems. On training, however, too much emphasis is placed on short-term courses. Human-resource planning should include a combination of in-house training, support for cooperative courses at educational institutes, and various types of training leave, the Council says.

TARGETS

1. **Productivity growth of 1.5 to 2 per cent a year.**
2. **Employment growth of 1.5 to 2 per cent a year in order to lower unemployment to a range of 5 to 7 per cent by 1992.**
3. **Real GDP growth of 3 to 4 per cent a year.**
4. **Annual inflation of 4 per cent or less.**
5. **Net capital inflows of about 2 per cent of GDP or less.**
6. **A reduction of the federal deficit to 2.5 per cent of GDP or less by 1992.**
7. **The maintenance and improvement of existing social policies.**
8. **Regionally balanced growth, employment opportunities, and social infrastructure.**

Multinationals welcome free trade

American subsidiaries in Canada are unlikely to close plants or to lay off workers in response to the free-trade deal with the United States.

At the same time, Canadian multinationals – which have become increasingly important in recent years – will be able to keep more jobs in Canada, according to a new discussion paper done for the Council's project on trade policy options (see *Au Courant*, vol. 8, no. 4). The paper, by University of Toronto international business professor Alan Rugman, focuses on the linkage between international trade and the international investment activities of both U.S.- and Canadian-owned multinationals.

The research provides new insights into the activities of Canadian-owned multinationals in particular. For one thing, these firms export about five times as much as they import from their U.S. subsidiaries. (That trade is partly offset by the purchases of U.S. subsidiaries in Canada from their U.S. parents.) Secondly, Canadian direct investment in the United States has been outpacing U.S. direct investment in Canada since 1975. Today, the Canadian stock of direct investment in the United States is valued at about 60 per cent of the U.S. stock in Canada.

U.S. subsidiaries

As for U.S. subsidiaries in Canada, Rugman discloses new evidence that calls into question the belief that many of these firms – originally attracted to Canada to avoid tariffs – will reduce operations or shut down once trade barriers are removed. Since U.S. subsidiaries in Canada export about 25 per cent of their output, "they can hardly be classified as being in Canada entirely" for that reason, he explains. "Many of the U.S. operations in Canada form part of a larger strategically integrated network of companies."

Furthermore, many U.S. plants in Canada have invested heavily in capital equipment, buildings, and other sunk costs that will minimize their sudden departure. Most of them also have access, among other things, to the production and marketing expertise of their parents; hence they will not lose their competitive advantage once trade liberalization occurs.

When trade barriers are removed, companies will reassess the competitiveness of producing in Canada against global marketing and production opportunities. Rugman believes that Canada will retain and attract foreign direct investment "if there is a good business climate." It will lose out, however, "if there are perceptions of arbitrary government regulations, taxes, tariffs, or a lack of national treatment for investment," he adds.

The favourable economic climate following trade liberalization "will probably lead to greater inflows of direct investment from third countries, including Japan and European nations," Rugman maintains.

Benefits to Canada

The opportunities for Canada's multinationals will grow with or without trade liberalization, the author points out. With free trade, more production will remain in Canada, adding to exports and jobs.



Without it, more firms will invest in the United States and hence more jobs will be created there. Even in this case, however, Canadian subsidiaries in the United States will purchase a proportion of their inputs from their Canadian parent firms. Dividends will also be remitted to Canada, thereby increasing the national income and the potential for job creation.

As part of his research, the author studied 36 multinationals with net sales of $1 billion or more and assessed how they would react to trade liberalization by examining their competitive strategies. The results suggest that the managers of these firms are "well equipped to pilot their firms through the shocks of new trading regimes," Rugman finds. Both Canadian and U.S. multinationals in Canada are expected to undergo minimal adjustment, in fact, because their competitive advantages are not dependent upon trade barriers.

Survey results

These theoretical findings are supported by the results of a survey of the chief executive officers of the largest Canadian and U.S. multinationals operating in Canada (21 Canadian and 17 U.S. multinationals). Both groups are strongly in favour of trade liberalization, and they anticipate increased employment as a result. Neither group said it required a long phase-in period, a devalued exchange rate, or adjustment assistance. While each of them views trade liberalization as likely to improve their performance, the U.S. companies were more bullish. Together, the findings suggest that large multinationals will "bear the burden of adjustment to trade liberalization as a normal part of their strategic management," Rugman concludes.

Since multinationals account for about 70 per cent of bilateral trade between Canada and the United States, the prospect of trade liberalization is not as disruptive as some might expect. He notes that the single most important finding of this study is that trade liberalization will be welcomed by multinational enterprises.

In view of the vital role played by multinationals in bilateral trade and investment, the author believes that it is essential to involve senior managers of these corporations in the discussion of any new bilateral trading regime.

"Trade liberalization and international investment," by Alan Rugman. Discussion Paper No. 347.

Health-care policies safe

Canada's principal health-care policies are unlikely to be jeopardized by the Canada-U.S. Free-Trade Agreement.

On the question of universal medicare in Canada, the free-trade deal "need not be viewed as a threat," says University of Ottawa economics professor Pran Manga, in a new discussion paper done for the Council. The bilateral agreement could, however, adversely affect certain non-medicare services, such as nursing-home care and the medical-devices industry. It will also lead to more private management of health-care institutions and programs, including a greater number of for-profit hospitals.

Those who argue that free trade will threaten universal medicare contend that the United States will view Canada's publicly financed health-care system as a direct subsidy to all employers. But Manga points out that about 40 per cent of health-care services in the United States are publicly financed as well (compared with about 75 per cent in Canada). The purchase of private health insurance is also subsidized under the U.S. tax system.

Indirect costs

Furthermore, even though health-care services receive more direct subsidies in Canada than in the United States, employers in Canada pay indirectly through corporate taxes. (Employers in most provinces also pay some health-care costs directly, through contributions to workmen's compensation boards, while in three provinces and one territory they contribute to their employees' health-insurance premiums.) The suggestion that Canadian employers are more heavily subsidized than their U.S. counterparts would result in a "complex and ultimately futile comparison" of corporate tax rates and structure, among other things, Manga says.

Moreover, it would be ironic for the United States to press Canada to give up social policies that pursue the objectives of equality of opportunity – a principle that is enshrined in both the U.S. and Canadian constitutions. To concede to any U.S. demands calling for the demise of universal medicare or such policies as universal education "would be an abject capitulation of our sovereignty," he adds.

Private hospitals

The possibility of more for-profit hospitals in Canada is not a threat to medicare either, as long as provincial governments continue to control hospital budgets, Manga says. With this power, the provinces could regulate the profit margins and the number of for-profit, private hospitals. (Large multinational U.S. hospital corporations might, as a result, be less inclined to invest in Canada.) In addition, the provinces could enforce the codes and regulations that govern hospitals in providing services.

Nursing homes

Much of the nursing-home industry in Canada is already privately operated, Manga notes. The U.S. investment in this industry is likely to increase, as long as the Canadian industry remains profitable. With an aging population, there will likely be continuing growth in the demand for nursing-home beds in the future. But Manga is concerned about U.S. involvement in this industry, because U.S. firms "have not been well disposed towards government regulations." They are likely to resist existing Canadian controls and regulations, he warns.

In the area of dental care, the trend towards prepaid dental plans is likely to accelerate under the free-trade deal.

Medical costs

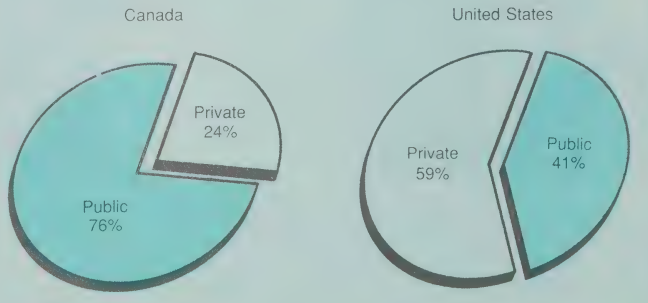
The free-trade agreement is unlikely to reduce health-care costs in Canada, since most equipment, drugs, and supplies already enter Canada duty-free. In particular, Manga looks at two health-care industries that involve the production and trade of medical goods. In the medical-devices industry, he finds that the free-trade deal is likely to dash any hopes of expansion in Canada. The removal of tariffs may adversely affect the investment decisions of U.S. firms by making it less attractive for them to manufacture products in Canada.

In the pharmaceutical and biological-products industries, the free-trade deal will "at best preserve the status quo," Manga concludes. Much of the pharmaceutical industry is foreign-owned. The biological-products subsector is made up of very few firms and is largely Canadian-owned. Because the pharmaceutical industry lacks a basic, pharmaceutical fine chemical (fermentation) industry, it imports active ingredients, then formulates and packages them for the local market. This is a major constraint to the development of an advanced biotechnology-based industry.

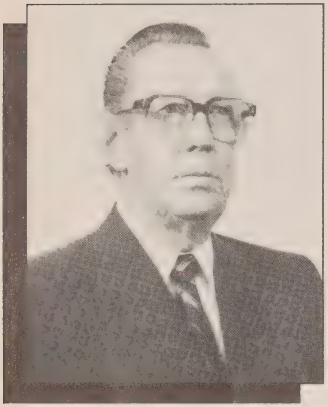
"The Canada-U.S. Free-Trade Agreement: Possible implications on Canada's health care systems," by Pran Manga. Discussion Paper No. 348.

Financing health-care costs

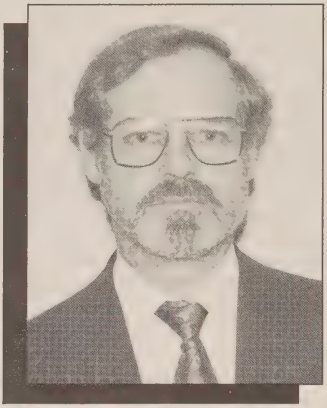
Private and public expenditures as a share of total, Canada and the United States, 1984



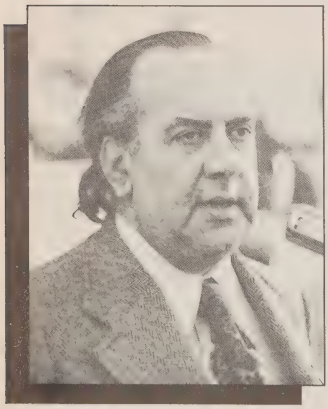
New members appointed to the Economic Council



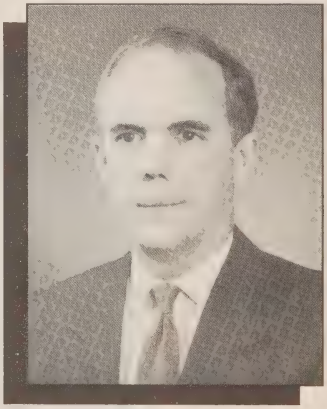
Alan Borger is President and Chief Executive Officer of several Manitoba-based firms including Borger Industries Ltd. and Ladco Company Ltd. A graduate of the University of Manitoba, he is a former director of the Winnipeg Symphony Orchestra and a past president of the Prairie Road Builders Association and the American Public Works Association.



Thomas Courchene was recenlty appointed Director of the School of Policy Studies at Queen's University, after serving as a Professor of Economics at the University of Western Ontario for many years. He has also served as Chairman of the Ontario Economic Council, as Senior Fellow of the C. D. Howe Institute, and as a member of the editorial board of the Fraser Institute. He is a graduate of the University of Saskatchewan and of Princeton University and has written widely on Canadian economic and social policy.



Marcel Pepin is Professor Emeritus of Labour Relations at the University of Montreal. Active in the labour movement for many years, he is former president of the Confederation of National Trade Unions and of the World Confederation of Labour. He is a graduate of the Montreal Seminary and Laval University and has been a member of the North-South Institute since 1982 and has also served on the board of directors of l'Imprimerie Populaire Ltée.



Léon Courville is Executive Vice-President of the National Bank of Canada. He was Director of the Institute of Applied Economics and Professor Emeritus at l'École des Hautes Études Commerciales before joining the National Bank as Vice-President and Chief Economist in 1984. He is a graduate of Collège André Grasset, l'École des Hautes Études Commerciales and Carnegie-Mellon University.

People, social change, and pensions

Council Deputy Chairman Harvey Lazar was asked to speak about the impact of changing demographics and social trends on Canada's pension system at the Canadian Pension Conference in Vancouver recently. Following is an edited version of that speech.

For some years now policy makers have been concerned with the impact of changing demographics and social trends on our pension and benefits system. When large numbers of the baby-boom generation reach retirement age, for example, it is argued that they will constitute an increasingly heavy burden on the relatively small labour force at that time. Does "intergenerational equity" – the concept of fairness between generations – require us to alter the system now, in view of the possible burden on future workers?

One way of looking at the impact of demographic developments is to examine "dependency ratios" – the number of young and old people (below age 20 and above 65) relative to the number of people of work-force age. I have chosen instead to focus on the size of the dependent groups (young and old) as a percentage of the actual labour force and of the total population. What this shows is that the proportion of people in the labour force 40 years from now relative to the total population is expected to be roughly the same as it is today. The ratio of those aged 65 and older, on the other hand, will be roughly 2 1/2 times higher. Obviously this has implications for social expenditures in the years ahead.

Social expenditures

To estimate the impact of the rising number of elderly on social expenditures in Canada, the assumption has been made that existing expenditures have been frozen, either at current per-capita benefit levels or at the current level of use. For example, the numbers assume that 40 years from now an 80-year-old person will use the same amount of health services as an 80-year-old does today.

In this hypothetical scenario, social spending would rise from 21 per cent of gross national product (GNP) in the 1980s to just under 30 per cent by the year 2031. Income benefits for the elderly would increase by almost 300 per cent, and health-care costs would rise by nearly 80 per cent. The costs associated with the young (such as child benefits and education) would fall by less than 20 per cent.

On the other hand, the economy is also likely to continue growing. Thus productivity growth will be crucial to the size and affordability of social programs. For example, even a 1-per-cent annual growth rate in productivity – low by historical standards – would reduce the social-spending burden to below 20 per cent of GNP by the year 2031. With attention to productivity growth, the demographic trends alone are unlikely to overwhelm future generations of workers and taxpayers.

With attention to productivity growth, the demographic trends alone are unlikely to overwhelm future generations of workers and taxpayers.

At the same time, whether or not the costs being passed on to future generations are fair will depend on the totality of the assets and liabilities that are bequeathed to them. On the asset side, that legacy will include the state of our environment and the quality of our work force, for example. On the liability side, the huge public debt could remain a problem in the years ahead.

Social trends

As for social trends, there are a number of developments that may impact on the benefits system in the future. One is the trend towards early retirement. For example, with retirement fixed at age 60 instead of 65, the old-age dependency ratio in the year 2031 would increase by almost a third. Another development is the growing number of working women, which has increased the size of the labour force. But this has also been accompanied by a fall in the birth rate, which could affect dependency ratios in the future. Furthermore, women's preferences in the future are unknown. For example, would universal day-care increase the birth rate without a significant drop in female participation in the labour force?

The changing nature of the traditional family unit also has implications for the future of the benefits system, as does the changing face of poverty in Canada. In regard to the latter, poverty among the elderly has decreased markedly over the past 20 years; their incomes have nearly doubled over that period.

Possible impacts

What are some of the possible impacts of these trends? First, since the elderly are no longer among the neediest groups in society, major increases in public pension programs seem most unlikely (particularly in light of the tight fiscal position of governments). Second, there will be continued pressure to rationalize social expenditures, including a debate on the future of the Old Age Security program. Third, in view of the changing economic role of women, the pressure to introduce a homemaker pension could subside. With fewer homemakers, on the other hand, such pensions could also become more affordable. Fourth, the demands on the benefit system will become more varied, in order to meet the needs of different lifestyles. Finally, the benefit system may become more "individualized"; benefits will accrue to the individual regardless of marital status.

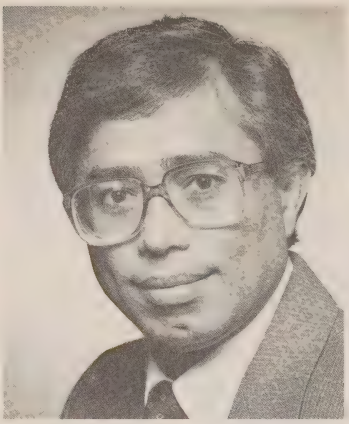
Other trends

Trends in pension coverage, portability, and indexing will also determine how well future pensioners will fare in their retirement years. As for coverage (including both pensions and registered retirement savings plans), it is growing. Portability has improved. And while indexing for inflation remains a thorny issue, progress has occurred. It is still unclear whether the public and private retirement income system is large enough for future generations of pensioners. But, on balance, Canada is at least moving in the right direction.

S·P·E·A·K·I·N·G · O·U·T

Despite five consecutive years of economic growth since the 1982 recession, high unemployment persists in some regions of Canada.

Even nationally, the unemployment rate has averaged much higher in recent years than it did over the past few decades. It rose from about 4 per cent during the mid-1970s to about 9 per cent in 1987. From 1982 to 1986, it exceeded the 10-per-cent mark, reaching a high of 12.8 per cent during the first quarter of 1983. Only recently has the unemployment rate begun to decline. What accounts for the high and persistent rate of unemployment? The Economic Council is examining that question as part of a new project on unemployment issues. To learn more about it, *Au Courant* spoke with project director Surendra Gera.



Surendra Gera

Au Courant: *Why is the Council undertaking this project?*

Gera: The experience of the 1980s has been one of high and persistent unemployment. It has led to a number of worrisome developments in the Canadian labour market. The divergence in regional unemployment rates has grown over this period primarily as a result of the recession of 1981-82 and the uneven recovery thereafter. There has been a dramatic increase in the proportion of long-term unemployed (individuals who are continuously unemployed for a year or more). While unemployment rates have been declining since 1985, the average duration of unemployment and the number of individuals who experience long-term unemployment remain high. We want to find out why unemployment has gone up and why it has become so persistent.

Au Courant: *What will the project examine in particular?*

Gera: The project will look at various issues related to unemployment and, for example, review the origin and development of the "full-employment" objective in Canada. The full-employment objective in Canada was set out in the White Paper on Employment and Income in 1945. The objective was generally to achieve a level of employment at which everyone who was able and willing to work could find a job. Is that a valid objective today? What trade-offs are involved in pursuing a full-employment strategy? How real and inevitable are those trade-offs?

Second, we shall examine the current high level of unemployment to determine whether it is mainly cyclical, or structural in nature. By cyclical I mean the unemployment associated with a cyclical downturn in economic activity, such as the 1981-82 recession. The term "structural unemployment" refers to the unemployment that remains even after the recovery in economic activity that follows a cyclical downturn. This type of unemployment arises primarily as a result of a mismatch between labour demand and labour supply. For example, in recent years the shift in economic activity from the manufacturing sector to service industries has contributed to structural unemployment.

Any unemployment other than cyclical is also referred to as "the natural rate of unemployment." Economists like to call this natural rate the "nonaccelerating inflation rate of unemployment" (NAIRU). Most economists believe that every economy has a certain rate of unemployment that is consistent with stable rates of inflation. The gap between the actual unemployment rate and the NAIRU serves as an indicator of the slack in the labour market. The NAIRU can vary over time because of such factors as the demographic composition of the labour market, the level of skills within the labour market, and changes in the laws pertaining to unemployment insurance benefits. We shall determine whether the current unemployment rate is still slightly above the NAIRU. We also want to look at the NAIRU from a regional perspective because of the considerable differences in unemployment rates across regions.

Third, an essential feature of the unemployment problem is its dynamic character. By this, I mean that individuals are constantly moving into and out of periods of unemployment as they change jobs, for example. It is important for policy makers to know how much of the unemployment is long-term and whether that long-term unemployment is sensitive to cyclical conditions. If that should be the case, then long-term unemployment should diminish as the economy recovers from a cyclical downturn. A major question in this regard concerns the time it takes for long-term unemployment to decline. In Canada, the proportion of long-term unemployed has fallen sharply in 1988, six years after the recovery. Nevertheless, the proportion remains high compared with its pre-1981 levels.

Fourth, we shall be investigating whether high unemployment stems from the failure of real wages to adjust to changing labour-market conditions, particularly to changes in the rate of productivity growth. For example, in the recent recession workers may have been laid off instead of taking wage cuts. Similarly, employers may continue to pay high wages during an economic downturn in order to maintain productivity and to avoid the costs associated with firing and the eventual hiring and training of new workers when the economy picks up again.

Au Courant: *At this point what does your research indicate as the reason for unemployment being so much higher today than in the past?*

Gera: Our research is still in progress. Some of it indicates that the economy is operating at close to the NAIRU and that there is not much room to exercise expansionary fiscal or monetary policies (to reduce unemployment) without reigniting inflationary pressures. The research shows that the structural imbalances – the mismatch between vacant jobs and the skills or location of unem-

ployed workers – grew over the 1966-86 period. A large proportion of the rise in structural unemployment occurred from 1976 onward. The research also shows that regional economic disparities and the increasing proportion of long-term unemployed have contributed to the growth in structural unemployment. At the same time, in a dynamic economy with constantly changing patterns of demand, some amount of structural unemployment is inevitable.

Au Courant: *How do we deal with structural unemployment?*

Gera: Since structural unemployment generally arises because of a mismatch between workers and jobs, in terms of their skills or location, obviously we need to have the right training policies to encourage skill development, as well as mobility. Structural unemployment cannot be reduced permanently through expansionary macroeconomic policies. Microeconomic policies such as training programs, on the other hand, can ease the adjustment process in matching workers and jobs. In this regard, for example, it is important to concentrate on skill-development programs to develop the service-sector work force, because that sector accounts for an increasingly large proportion of employment.

Another factor that has become important in terms of structural unemployment is that our resource-dependent regions have experienced a terms-of-trade loss. As a result, those regions have suffered a real income loss, and many jobs have simply disappeared. In this case, training and worker-mobility programs may not be the most appropriate solution. Instead, governments have to determine how they can reduce the sectoral shocks of recent years (the downturn in oil prices and some agricultural prices, for instance), perhaps by encouraging economic diversification.

To the extent that the growth in the number of long-term unemployed contributes to structural unemployment, we need to consider specific policy measures to encourage employers to hire the long-term unemployed. Potential employers may be reluctant to hire someone who has been out of work for many months. At the same time, individuals who have been unemployed for long spells may become discouraged and reduce the intensity of their search for work.

Au Courant: *How does Canada's record of unemployment fare against that of other countries?*

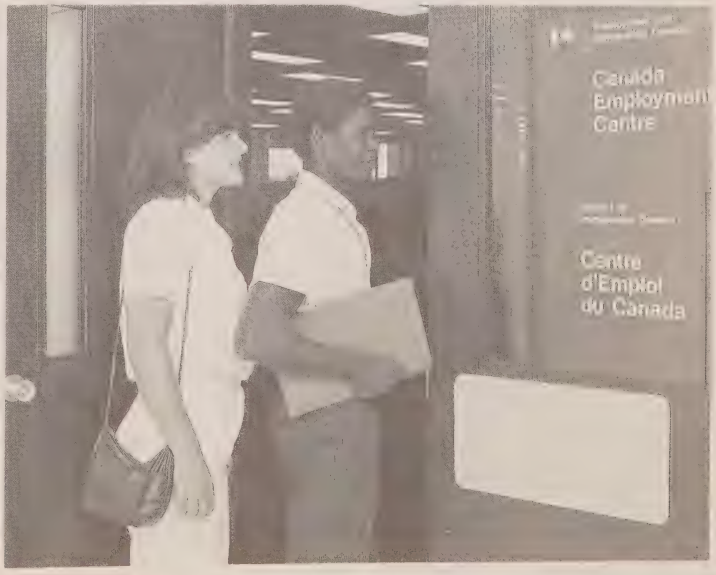
Gera: The 1980s have seen a significant rise in unemployment in all the developed countries. The unemployment rate for countries in the Organisation for Economic Co-operation and Development was 8.3 per cent in 1986 – up 56.6 per cent from the rate prevailing in 1979. Since the beginning of the current international recovery in the early 1980s, only three countries – Canada, the Netherlands, and the United States – have registered a relatively significant decline in their unemployment rates. Even for these countries, however, the current rates are very high in comparison with those prevailing in 1979. While unemployment has drifted steadily upward since the 1960s, that trend has been much more marked in Europe than in North America and Japan.

Au Courant: *What will the output of your project consist of?*

Gera: Most of the output will be in the form of working papers and research studies. It will also provide input to the Council's Annual Review of the economy and to the Council's project on employment and the service sector economy. The mandate of the project is basically to update the research on unemployment.

The mismatch between vacant jobs and the skills or location of unemployed workers has grown over the 1966-86 period.

There has been a dramatic increase in the proportion of long-term unemployed.



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WORKING TO IMPROVE CANADA'S POLICY PERFORMANCE

. . . that has been the chief concern of the Economic Council of Canada since its creation as an independent advisory body in 1963.

Over the past two decades, the Council has focused on public policy issues of key importance to Canadians — including economic growth, the role of new technology, the impact of government regulation and the changing job market, to name only a few.

The Council pursues its goal of improving Canada's economic performance in three ways:

Consultation

Members of the Council, representing a wide cross-section of Canadian society, meet regularly with governments and groups to study, analyse, and make recommendations on significant economic issues.

Research

An expert staff originates research and provides background information on a variety of topics, with particular stress on the medium- and longer-term problems of the Canadian economy.

Information

The need for better information on economic issues has led the Council to place strong emphasis on its contact with the public, through the use of topical publications, speeches, conferences, workshops and media relations.

Economic Council of Canada

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au courant

Economic Council of Canada

Volume 9, No. 3, 1989

Perspective 2000



- Handling the risks
- Free trade and the productivity gap
- Trade: Competitiveness is the key

PUBLICATIONS

Council Report

Handling the Risks: A Report on the Prairie Grain Economy (EC22-154/1988E; $9.95 in Canada , US$11.95 elsewhere).

Prairie grain farming is becoming riskier, and Prairie farmers are more dependent than ever on government support. In 1987, over 90 per cent of net farm cash receipts in the Prairies came from government transfers. But massive assistance will not solve the underlying international and domestic problems. Farmers' income has always fluctuated with the weather. Over the past 15 years, changes in the international market have added to the uncertainty. A wider and more secure access to foreign markets is thus a priority for Prairie farmers. Prairie farmers also need help in stabilizing their incomes. Many borrow more to produce more, as the long-term real price of their output declines. Faced with this cost-price squeeze, only the luckiest and most efficient farmers survive. Mandated by the Prime Minister to examine the future of Prairie agriculture, the Council sees that future as bright but risky. Federal and provincial policies must change, if Prairie grain farmers are to survive and recover their entrepreneurial role.

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than to the Council. Five new titles have been published since the last issue of *Au Courant*.

Trade Liberalization and the Multinationals, by D. G. McFetridge (EC22-156/1989E; $5.95 in Canada , US$7.15 elsewhere).

Grain Market Outlook, by W. H. Furtan, T. H. Bayri, R. Gray, and G. G. Storey (EC22-153/1989E; $9.95 in Canada , US$11.95 elsewhere).

The Taxation of Income from Capital in Canada, by M. J. Daly, P. Mercier, and T. Schweitzer (EC22-155/1989E; $5.95 in Canada, US$7.15 elsewhere).

Canada and International Grain Markets: Trends, Policies and Prospects, by C. Carter, A. F. McCalla, and A. Schmitz (EC22-158/1989E; $9.95 in Canada, US$11.95 elsewhere).

Regulatory Failure and Renewal: The Evolution of the Natural Monopoly Contract, by J. R. Baldwin (EC22-157/1989E; $11.25 in Canada, US$13.50 elsewhere).

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the sole responsibility of the author, or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 358 "Adjusting to trade: A comparative perspective," by *M. J. Trebilcock, M. Chandler,* and *R. House.*

No. 359 "The diversification of Prairie agriculture: Opportunities arising from changes in the international trading environment," by *William A. Kerr.*

No. 360 "A review of the economies of farm enterprise size and implications for farm diversification," by *William J. Brown.*

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion papers, *Au Courant* and the *Annual Report* are available without charge from the Publications Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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Au Courant *est également disponible en français.*

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its staff and others. The findings of these reports are the personal responsibility of the authors. Neither the original publication of these studies and papers, nor their condensation for the purposes of this magazine, should be taken to imply endorsement of their conclusions and recommendations by the members of the Economic Council.

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Editor: Jean-Guy Bruneau

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Perspective 2000

Last year, as part of its 25th anniversary celebrations, the Economic Council undertook to identify a wide range of public policy issues this country could face at the turn of the century and beyond. This major project was named *Perspective 2000*.

From its inception, Perspective 2000 has had three distinct characteristics. First, it is concerned with the longer run – with 21st century issues. Second, it addresses not only economic questions, but those relating to geopolitics, science and technology, demographics and the environment – and perhaps most important, it examines the linkages amongst each of these areas. Third, Perspective 2000 asks questions not only from the Canadian viewpoint, but in an explicitly global context.

Twelve eminent scholars were invited to prepare papers with a distinctly international flavour. Twelve discussants analyzed the material from a specifically Canadian viewpoint.

At a major conference held in Ottawa last fall, the 24 scholars presented thoughts to more than 80 business executives, senior public officials, labour leaders, media representatives, and other prominent decision makers.

Five former ECC Chairmen convened subject "blocks" and a plenary discussion of conference themes. Arthur J. R. Smith, André Raynauld, Sylvia Ostry, George Post and David Slater each played major roles at this unique gathering.

Economics, ecology, people, and technology

We must design management skills that will help us . . . in turning the future's unforeseen opportunities to our advantage, and in controlling its unforeseeable dangers within tolerable limits.

William Clark, Harvard University

In what was to become a recurrent theme of the conference, William Clark noted that humanity is entering an era of chronic, large-scale and extremely complex syndromes of global interdependence. In the next century, he said, conventional wisdom may not suffice to handle surprises in global interactions of demography, technology, and environment.

Clark feels that in order to be of value, long-term visions must eschew mechanistic predictions in favour of imaginative, though disciplined perspectives of what can be done.

Ecologist Pierre Dansereau argued that historically speaking, conventional wisdom has proven advantageous (or at least not harmful) for the survival of the group holding such views. But, he conceded, conventional wisdom is valid only as long as slow-changing trends hold. But echoing some of Clark's views, he said that in order to contribute to the larger theme of human survival through change, economics must reach beyond its traditional boundaries.

Global politics

Bill Maynes, editor of *Foreign Policy*, emphasized that historically, military technology has proven a fruitful path of inquiry when predicting geopolitical change. With the new technology becoming increasingly available worldwide, Maynes suggests that in the 21st century, the First World's Imperial Age will end. In the Second World – that of the communist states – the Revolutionary Age will end. In the Third World – that of the bulk of mankind – the Anti-Colonial Age will end. These developments may lead to more effective institutions of international governance and/or the formation of regional blocs.

The remaining challenge (of the G-7 – the western industrialized countries) during the 1990s is to transform from a northern plutocracy into a genuine global concert.

John Kirton, University of Toronto

Amplifying on Maynes' military technology path, International Relations Professor Kirton emphasized two aspects of technological and geopolitical interactions. First, he foresees an intensified science race between the two superpowers which will create a major arms control challenge. But as a counterbalance, the proliferation of television, particularly satellite broadcasting, will help the global populace to rise to political challenges as the technologies relay information without the intervention of governments.

A multi-polar economy

Jacques Lesourne of Conservatoire national des arts et métiers in Paris expanded on the international theme by noting that the global economy is becoming increasingly multi-polar. During the 1950s and 1960s, the United States was the dominant pole in the world economy; however the rise of Japan, the revival of European nations and the growing importance of Asia's newly industrialized countries have since given birth to a multi-polar economy, he said.

Lesourne projected that the "Triad" – the United States, Japan, and the European Community – will either move toward a U.S.-Japan duopole, or balanced development will occur in all three poles. From Canada's point of view, it will be significant whether the U.S.-Japan relationship will be asymmetric with America playing a dominant role, or a more symmetrical one.

A naive free-trade strategy relying on unaided markets is unlikely to be a panacea: what is needed is active management of trade.

Gilles Paquet, University of Ottawa

Public policy scholar Paquet sees Canada's main problems very differently, maintaining, in fact that our country suffers from a form of economic arteriosclerosis. He provided a long list of symptoms which, he said, distort the information base needed for clear economic decision making. Classical free trade will not cure our problems. As an alternative, he advocates managed trade, i.e., an offensive strategic trade and targeting policy.

Managed trade, says Paquet, can be feasible, acceptable, stable, and implementable – and the development of such an approach is our main task in the next decade.

Canada's global role

Having sketched out the global setting, the conference turned to Canada's role and "expected problems." UBC's John Helliwell agreed with preceding speakers

that globalization is of the utmost importance. One of the chief consequences of globalization is the dispersion not only of production, but of an ever-growing number of services, led by those of the financial market.

Picking up on the competitiveness aspect, Marcel Côté of Secor Inc., mapped out the future, using the years 1970 to 1985 – when a series of external shocks hit the Canadian economy – as a benchmark period.

In effect, Canada's economy will have four salient characteristics. First, natural resources (except agriculture) will continue their significant role. Second, manufacturing will continue developing and have greater flexibility. Third, we will remain a "follower" in technology, although we will continue to use new technologies to good advantage. Fourth, we will continue to be plagued with regional disparities, the reduction of which will remain a Canadian economic priority.

On the whole, Côté thinks Canadians will be better off, with a per capita national production at least 25 per cent higher, and a greater personal wealth – more goods, more land, more infrastructure.

But Professor Ken Norrie thought Côté's paper "incredibly optimistic," saying that in the past we have had to deal with a number of problems not mentioned by Côté, and we have not succeeded in solving them. At the same time, there has arisen a "protected society." How, argues Norrie, can the economy be flexible and adaptable when innumerable interest groups expect the government to protect them from the vicissitudes and disciplines of the marketplace?

Professor Lars Osberg of Dalhousie University presented a paper on distributional issues and the future of the welfare state. He looked at cyclical and secular influences on income distribution in Canada in the 1980s, emphasizing the importance of high unemployment in depressing labour's share of national income and in increasing the inequality of earnings and the incidence of poverty.

Evidence that structural change in employment opportunities may eliminate "middle class" jobs is inconclusive, he says. However the ongoing revolution in computer and telecommunications technology will have a major impact on the structure of employment in information processing occupations, which already comprise the majority of the labour force. An aging and more immobile population will create intergenerational inequities and accentuate regional disparity – and the increasing salience of environmental issues will heighten public awareness of distribution of environmental costs between current and future generations.

Discussant Thomas J. Courchene of Queen's University considers two variants: the Limited Welfare State and the Implicit Social Contract. Courchene prefers the first, because of its stronger reliance on market forces and its more decentralized nature. The Limited Welfare State seeks to abolish the universality of a number of social programs and target them to the "really needy" cases. The Implicit Social Contract model, as exemplified by the Scandinavian societies, is not, says Courchene, applicable under Canadian conditions of a widely dispersed, heterogeneous population in a federal state.

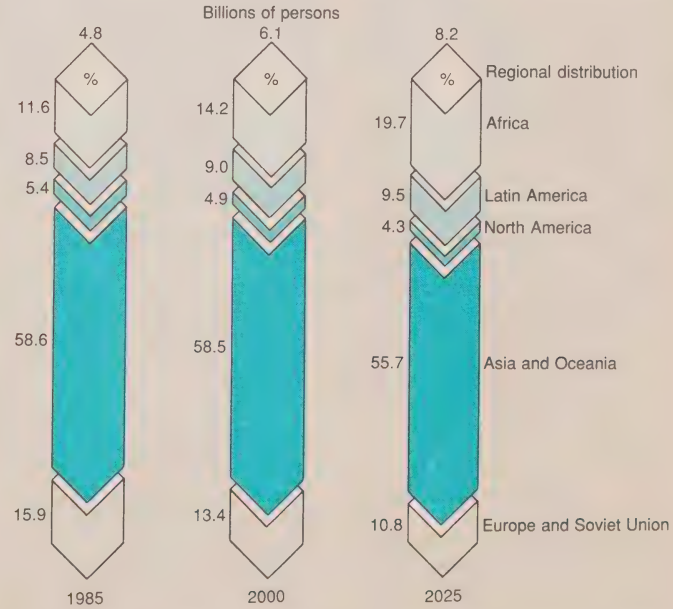
The human factor

The "union-free environment" goal and "anything goes to defeat unions" attitude of U.S. business are likely to spill over, at least in part, to Canadian management.

Professor Richard Freeman,
Harvard University

Freeman nevertheless contends that Canada need not follow the U.S. deunionization path and need not suffer major economic losses from increased foreign competition and the shift of manufacturing to the Third World. He warns, however, that to take advantage of

Actual and projected size and growth rate of the world population, by regions, 1985, 2000, and 2025



the changing scene, and to minimize the costs of adjustment will require greater flexibility and foresight on the part of all decision makers, substantial changes in trade union policies and possibly, initiatives to improve the wages of the least skilled workers.

Commenting on Freeman's paper, UBC labour economist Craig Riddell referred to growing anti-union sentiments in Canada, but noted we are more likely to see organizational and institutional adaptation in the industrial relations setting than the outright attack that characterizes the American scene. Riddell did, however, make the observation that when one considers the relationship between various countries' industrial relations systems and their economic performance, one sees that the best performers have either a high or a low degree of centralization of national wage setting: not, as in Canada, something in between. So the question is (supposing we will not follow a Swedish-style centralized bargaining system): will economic forces push us toward more decentralized, U.S.-style, wage setting systems?

Industrial relations expert Thomas Kochan of MIT supports the view that Canada need not follow the U.S. path but warns that to avoid the adversarial characteristics of adaptation to labour market changes, Canadians will have to shed traditional beliefs and practices.

"Labour will have to become more of a champion of innovation and adjustment at the workplace, and play a broader role in the management and governance of the enterprise." And governments will have to recognize that such industrial relations innovations are critical to the performance of the national economy, he said.

. . . it may be overly idealistic to expect a global economic revolution not to generate dislocation, readjustment, and reassessment.

Judge Rosalie Abella,
Canadian Labour Relations Board

While not disagreeing with Kochan's conclusions, Judge Abella is much less sanguine about the prospects for such institutional adaptation in the industrial relations field. For one thing, "Canadian labour has always resisted concession bargaining, profit-sharing, quality circles, and generally most of the collaborative approaches to the reduction of tension and the enhancement of productivity. . ." The need to respond to urgent short-run adjustment problems in the face of rapid change may well curb the development of longer-run, more collaborative strategies, she suggests.

. . . a lifetime career in a given occupation will be a thing of the past.

George Psacharopoulos, World Bank

The challenges facing global labour markets in an era of intensifying international competition, technological change, and institutional adaptation will include, in the final analysis, the fundamental sources of human resource development: education and training. Thus, in the view of World Bank economist George Psacharopoulos, the perennial dilemma of vocational versus general education will continue to dominate the public policy debate as we approach the 2lst century.

The strategic role of education in long-run economic development is emphasized by Professor Jeannine David-McNeil of Montreal's École des Hautes Études Commerciales, who argues that education policy is not just a question of social cost, but an instrument of economic growth. Thus, educational expenditures are a source, in the medium and long term, of income and prosperity.

Setting the framework

. . . meeting the challenge of the growth of government and restoring its effectiveness, manageability and accountability must be essential to any consensual prescription.

Ian Stewart

Former Deputy Minister of Finance Ian Stewart showed that with the decline of Keynesianism, it is the ideological and political foundations for the compromise of capitalist democracy that are under attack. *(Keynesianism extended the era of "political economy," and was concerned as much with the collective provision of social welfare as with the tools of macroeconomic management.)*

Stewart stresses that the absence of strong consensual agreement severely limits our capacity to improvise and sustain coherent public action to shape a strategic response to international competitive forces.

The capacity of governments and the institutions and conventions of government in Canada to respond to global forces is also the main topic of Professor Al Johnson's paper. He discussed how politicians and policy makers will perceive these forces, and what political forces and institutional limits they will confront in coping with them. Johnson argues that because Canada has been preoccupied with regional and cultural tensions, we tend to be an insular nation. As a consequence, the political agenda has been dominated by efforts to rectify these differences and by efforts to define our "nationhood."

Canada, in short, is an uncertain country, and like all uncertain countries, it has tended to be preoccupied with itself.

Al Johnson, University of Toronto

Johnson proposed a series of directions for change in order to address the nation's preoccupations with regional discontents. He also proposes clarifications to the spending power beyond what is now included in the Meech Lake Accord, and to the amending formula.

Ian McDonald disagrees somewhat with Johnson's prescription. He believes the problem is how to convince voters that global issues are also personal and local. The key, he thinks, is to ensure a much better understanding of the importance of the issues in personal lives.

Economists: Are we up to the task?

A blunt question indeed. Alan Blinder of Princeton examined the usefulness of economic science for policy making, using macroeconomics as a case in point. The once-symbiotic relationship between macroeconomic scholars and policy makers has, he says, reached the point where there is a "blend of tension and detachment seasoned with mutual disdain."

Block I: The Global Setting

Author: William Clark
Kennedy School of Government
Harvard University
Paper: The World Physical Setting in the Year 2000
Discussant: Pierre Dansereau
Université du Québec à Montréal

Author: Bill Maynes
Editor, *Foreign Policy*
Washington, D.C.
Paper: The Global Political Setting in the Year 2000
Discussant: John Kirton
Department of International Relations
University of Toronto

Author: Jacques Lesourne
Conservatoire national des arts et métiers
Paper: The World Economy in the Year 2000
Discussant: Gilles Paquet
University of Ottawa
Institute for Research on Public Policy

Block II: Canada's Place in the World Economy in the Year 2000

Author: John Helliwell
Department of Economics
University of B.C.
Paper: Globalization of the Canadian Economy
Discussant: Yoshihiro Tsurumi
City College of New York

Author: Marcel Côté
Secor Inc.
Montréal
Paper: Competition and Industrial Structure
Discussant: Ken Norrie
Department of Economics
University of Alberta

Author: Lars Osberg
Department of Economics
Dalhousie University
Paper: Distributional Issues in the Year 2000
Discussant: Tom Courchene
Department of Economics
Queen's University

Block III: Employment/Human Resource Development

Author: Richard Freeman
Department of Economics
Harvard University
Paper: Global Employment
Discussant: Craig Riddell
Department of Economics
University of B.C.

Author: Tom Kochan
Sloan School of Management
Massachusetts Institute of Technology
Paper: The Future of Industrial Relations
Discussant: Rosalie Abella
Ontario Labour Relations Board
Toronto

Author: Emmanuel Skoufias for George Psacharopoulos
World Bank, Washington
Paper: Future Trends and Issues in Education
Discussant: Jeannine David-McNeil
École des hautes études commerciales
Montréal

Block IV: Environmental and Institutional Framework for Economic Policy

Author: Ian Stewart
Former Deputy Minister
Finance Canada
Paper: Consensus and Economic Policy
Discussant: Richard Simeon
Queen's University

Author: Al Johnson
Department of Political Science
University of Toronto
Paper: Economic Decision-Making in the Year 2000
Discussant: Ian Macdonald
York International
York University

Author: Alan Blinder
Department of Economics
Princeton University
Paper: Is the Discipline of Economics Up to the Task?
Discussant: Rod Dobell
Institute for Research on Public Policy
Victoria, B.C.

He predicts, however, that the closer relationship may reemerge now that the new classical tide of economics is receding in favour of a resurgence of Keynesian economics which is now staging a come-back in Academia. But, "academic economists must reorient themselves in more empirical directions. They must focus more on the world as it is rather than on the world as they wish it to be."

Rod Dobell, President of IRPP, was the final discussant. His comments, for the most part, confirmed and underlined Blinder's argument. According to Dobell, the question of economics being up to the task can be taken well beyond economic policy in the sense of traditional macro-economics – to apply to economic aspects of regional, social, or environmental problems.

It was noticeable to a number of participants that economic decision makers from the public sector, in particular the federal government, found this discussion both stimulating and thought-provoking.

Future plans

Council staff are now engaged in reviewing and editing the commissioned papers, formal commentaries, and general discussion from the conference. The team will write short syntheses of each paper on the agenda. These, along with the full text of all papers and formal commentaries, will form the core of a volume of Papers and Proceedings, which will also contain a scene-setting introductory preface and an epilogue in which the team will draw out some of the major themes, conclusions, and future policy issues.

A much shorter version will also be prepared. This summary document and associated slide material will provide input for a series of workshops and consultations with various interested groups across the country.

Perspective 2000 was orchestrated by ECC Senior Research Director, Keith Newton. His team included economists Kathryn McMullen, Tom Schweitzer, Jean-Pierre Voyer, and Jac-André Boulet. Media relations were handled by Bob Douglas.

Handling the risks

While grain farming in the Prairie provinces remains viable, its increasing vulnerability means that major change must take place both in attitudes and in existing farm policies.

Canadian grain production continues to be internationally competitive and remains an important part of the nation's economy. Nevertheless, over the past 10 years grain farming has become fraught with greater risks than before.

In a report entitled *Handling the Risks*, the Economic Council of Canada concludes that the soundness of the Prairie grain economy is being undermined by income instability, overcapitalization, extremely low grain prices, and adverse weather conditions. But the Council is convinced that the vast Prairie farmland can still provide stable and reasonable incomes for many families if existing assistance programs are appropriately modified. To this end, the Council proposes a series of measures designed to rebuild the spirit of entrepreneurship among farmers, to restore profitability to their operations, and to give the agricultural sector the flexibility it will need to survive the challenges ahead.

Even though public outlays in agriculture totalled more than $4 billion in 1987 (including transportation subsidies), a great many farmers still face severe financial hardship. In 1985-86, about 23 per cent of farmers were in financial difficulty; by 1987 this figure had climbed to 28 per cent. In the same year, government transfers accounted for more than 90 per cent of net farm incomes.

The Council believes that the federal treasury simply cannot sustain this level of expenditure, not only because of the need for deficit reduction but also because this approach is contrary to the long-term interests of farmers. The current crisis can be seen, in some ways, as proof that existing assistance programs – focused primarily on production volumes rather than incomes – are inefficient.

The new Canada-U.S. trade agreement and the current round of multilateral GATT negotiations (if successful) will benefit Prairie farmers and Canadian consumers as a whole. Now is the time, says the Council, to restructure the assistance programs offered to Prairie farmers.

The Council began to study the difficulties facing Prairie farmers in 1986, at the request of Grant Devine, Premier of Saskatchewan. The Council's Deputy Chairman, Caroline Pestieau, assumed overall management responsibility for the project; the research was supervised by Andrew Schmitz, of the University of Saskatchewan and the University of California (Davis), and by Ludwig Auer, senior economist at the Economic Council of Canada.

Goals of a new agricultural policy

According to the Council's report, government support must be aimed at making farms more profitable and at helping farmers to be more competent and more dynamic in managing their operations. Agricultural policy should be improved so as to avoid a recurrence of the current crisis and to enhance the efficiency and independence of farmers. This will put them in a better position to handle the risks inherent in the grain economy.

Special programs, such as those set up in the last few years, sometimes have the appearance of rescue operations. They tend to distort market signals and to diminish the responsibility of farm operators. While recognizing that modern agriculture demands a great deal from farmers, the Council points out that management skills are sorely needed in the agricultural sector.

The Council took all of those factors into account when formulating its recommendations. These recommendations set six objectives:

- reduce income instability
- improve long-term competitiveness
- increase the autonomy of farmers
- promote the conservation of Prairie soils
- reduce interregional tensions among farmers, and
- lower government expenditures by incorporating a larger self-financing component into assistance programs and ensuring that the latter correspond to farmers' real needs.

Recommendations

On the basis of these objectives, the Council offers a series of recommendations designed to help farmers successfully weather the boom-and-bust cycles inherent in the grain economy. The following steps are recommended by the Council:

– The federal government should continue to support the work of the Farm Debt Review Boards. The federal and provincial governments are urged to consider developing mechanisms for encouraging private-sector equity financing.

– The *Western Grain Stabilization Act* should be amended to make all crops eligible for payments, and the levies paid by farmers for the stabilization fund should be tied to price fluctuations.

– Crop insurance should be made compulsory, and its coverage should be extended to pasture and forage. The government should consider offering a similar program to livestock producers.

– The Farm Credit Corporation and provincial credit agencies should base their subsidy decisions on the repayment capacity of farm borrowers rather than on the value of their farm assets. The purpose of loans should be to enhance productivity rather than to finance land purchases.

– The capital-gains tax exemption should be modified to allow farmers to claim a tax deduction on certain capital gains in order to diversify their financial risk.

– Assistance to farmers wishing to change occupations should be improved.

– Farm-management training programs should be developed that are targeted at present needs and at opportunities for diversifying farm output. These programs should be developed in cooperation with the private sector and farm organizations.

– A Conservation Reserve Program should be set up, under which farmers who convert lower-yielding grain acreage into forage or pasture would be financially compensated.

The Council also puts forward some specific recommendations for an improved international trade environment. If the current round of GATT negotiations succeeds in liberalizing grain trade, the Council recommends that farm-income support be "decoupled" from the cultivation of particular crops and that transportation subsidies be gradually reduced.

A decoupled support system

Prairie farmers are plagued by two main problems: low farm incomes, and income instability.

The Council's research indicates, however, that not all farmers are affected to the same degree and in the same way. Low farm incomes are found primarily on small marginal farms, while the problems faced by the larger commercial farms stem primarily from unstable incomes.

The various farm-support programs established to alleviate these two problems have had, to say the least, inconsistent results, since they are generally tied to the production of specific commodities – the more a farmer produces, the more the government pays. This mode of support raises farm prices, obscures real production costs, encourages excess production, and changes the competing position of exporting countries.

Subsidies also open the door to the adoption of *ad hoc* programs in response to lobbying by farm pressure groups. The end result is a patchwork quilt of programs without consistency.

The Council's solution to this problem is to base support not on output or acreage, but on farm incomes.

An advantage

While the concept of "decoupled" support will not, in itself, solve the problem of low farm incomes, it has the advantage of being commodity-neutral. It will not encourage excess production and so will help to stabilize farm incomes. This may represent one solution to the international and domestic problems mentioned earlier.

Decoupled support involves tailoring government assistance to the particular situation of individual farms. This will necessarily require that a "program file" be set up for each operator. The administrative requirements of adopting such a personalized approach could be simplified by the use of income tax files.

An approach to decoupled income support

The Council has developed four examples of income-support programs to illustrate the potential advantages of decoupling government support to farmers. They are as follows:

- farm-income insurance
- income-stabilization fund
- farm adjustment option, and
- family-income disaster assistance.

Farm-income insurance: This program is designed to protect farmers against major farm-income losses caused by unfavourable market prices or adverse weather conditions. Farmers would receive cash payments whenever their farm incomes dropped below "normal" levels (calculated as the average of the previous five years). There would be a ceiling of, say, $60,000 a year. Government and farmers would share the cost of the program on an equal basis.

Income-stabilization fund: This program would encourage farmers to invest a portion of their farm incomes in a self-administered fund during good years to guard against future income losses. In this way, the cost of farm-income insurance would be reduced. This investment would also be tax-deductible. Government would match farmers' contribution on a one-to-one basis.

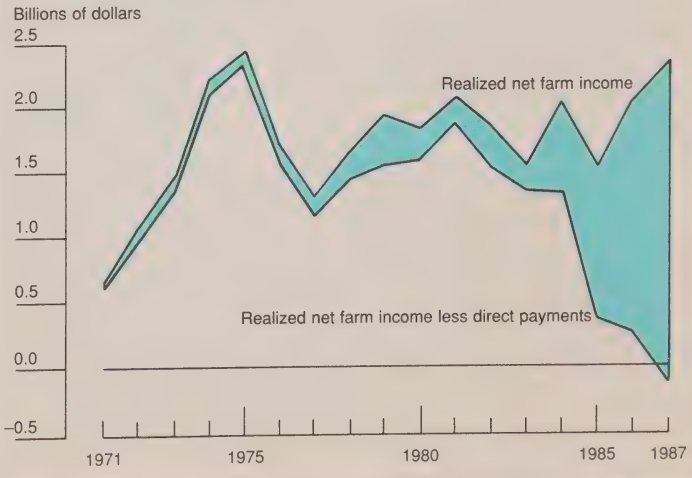
Farm adjustment option: A farmer would be entitled to withdraw the accumulated balance in his stabilization fund, including the government's matching contribution, when he decided to quit farming. This amount would be tax-free and treated in the same way as a tax-free capital gain from the sale of farmland. A maximum of $500,000 would be set for such tax-free capital gains.

Family-income disaster assistance: This program would be triggered when provincial or regional farm incomes dropped to disastrous levels. Farmers with incomes below $14,000 would be provided with cash payments up to a maximum of $7,000.

These four examples of decoupled support programs were designed to provide maximum benefits at lowest cost. Their objective is to ensure that farmers enjoy the same protection as they do under existing programs, but at a better cost and without ignoring market signals.

The potential gains to be made in efficiency, self-reliance, and income stability make decoupling a worthy objective in the medium to long term.

Direct government payments and realized net income, prairie region, 1971-87



Free trade and the productivity gap

The sizeable manufacturing productivity gap that has grown in recent years between Canada and the United States could be narrowed as a result of the Free-Trade Agreement between the two countries says an Economic Council of Canada researcher.

P. Someshwar Rao, a senior economist at the Economic Council, also contends in his recent discussion paper, that productivity and living standards are likely to be influenced in a number of important ways by free trade, such as speeding up the reallocation of resources from declining to growing industries, accelerating the implementation of new technology and improving the operating efficiency of markets. With the size of the market available to Canadian producers expanded, it will also be possible to lengthen production runs and therefore benefit from economies of scale and the specialization of production.

While the real gains in efficiency are often hard to measure, says Rao, the net long-term output and real income improvement from freer trade could be quite significant. Closing the size of the productivity (GDP per person employed) gap between the two countries will be a measure of the extent that progress is achieved.

The researcher addresses the following questions in his study.

- Is there an overall productivity gap between the United States and Canada?
- If so, how much of that gap can be attributed to the poor performance of Canadian manufacturing productivity?
- Why, after 1970, were Canadian manufacturing firms unable to close the productivity gap significantly vis-à-vis their U.S. competitors?
- What caused the further deterioration between 1980 and 1987?

The evidence

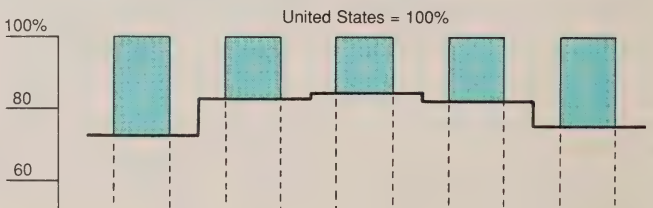
Canada's measured income per capita and overall labour productivity have traditionally trailed the levels achieved in the United States. But over the past 25 years Canadians have made substantial improvements in their relative economic performance. Rao points out, for example, that Canada's per capita income increased from 71 per cent of the U.S. level in 1961 to about 91 per cent in 1980. He notes, however, that Japan, Germany, France, and Italy managed even more impressive performances over the same period.

Most of the relative improvement in income per capita occurred in the period 1965-75, following the Kennedy Round of GATT trade liberalization, the signing of the Canada-U.S. Auto Pact and the commodity price boom and favourable terms of trade in the early 1970s. In most of those years Canada was achieving annual overall labour productivity increases of 3 per cent or more. By 1975 Canada's overall productivity level had risen to 86 per cent of the U.S. level. Subsequently, with the baby boom generation entering the labour market, and with the OPEC energy price shock and mounting inflationary pressures, the growth rates of annual productivity slowed both in Canada and in the United States. But overall, by 1986 Canada's aggregate productivity had moved up to 91 per cent of the U.S. level.

The big exception was manufacturing. In 1961, labour productivity in Canadian manufacturing was roughly 73 per cent of the levels being achieved in U.S. manufacturing. Subsequently, through modernization, Canadian firms were able to close part of the gap; by 1970 their productivity levels were about 82 per cent of their U.S. counterparts. That gap of 18 per cent persisted throughout the 1970s. Then after 1980, North American inflation rates sky-rocketed, followed by the worst recession since the 1930s. The Canadian economy was much more severely hit than the American and Canadian manufacturers suffered. Despite widespread lay-offs, plant closures and restructuring in both countries the manufacturing productivity gap widened to 25 per cent.

How has Canada successfully narrowed the overall productivity and per capita income difference with the United States in the face of a widening manufacturing productivity gap? Evidently because in sectors other than manufacturing (construction and transportation for example) Canadian enterprises achieved productivity growth rates greater than those in the United States. The upshot has been that the contribution of manufacturing to the remaining overall productivity gap has gone up from 20 per cent in 1960 to 55 per cent in 1987. This implies that improvements in Canada's manufacturing performance are crucial if overall productivity and real income differences

Manufacturing productivity gap between Canada and the United States



between the two countries are to be further reduced.

Some explanations

Rao develops a model that allows him to measure what factors have contributed most to manufacturing productivity performance in both Canada and the United States, and thus to account for the narrowing and widening of the manufacturing productivity gap. The results are quite robust, and effectively explain roughly 90 per cent of the causes of variations in the gap. They include the following observations.

- Other things remaining constant, Canadian manufacturing productivity growth will normally exceed U.S. manufacturing growth and thus narrow the productivity gap. This could reflect one of several phenomena – a process of technological "convergence" in which Canadian firms borrow and apply the technology of the U.S. "leader"; the faster growth of the Canadian economy and population relative to the United States; or the greater responsiveness of Canadian manufacturing firms to international competition.
- However, escalating energy prices have hurt Canadian manufacturers more than American. They have contributed to slower technical progress and higher rates of inflation in Canada than in the United States.
- In the United States profits count. When U.S. manufacturers achieve a growth of sales that outstrips the growth of wages and other costs, this tends to create a virtuous cycle of improved productivity and competitiveness, and widens the U.S./Canada manufacturing productivity gap. Surprisingly the relationship between profitability and output growth in Canada is relatively weak.
- Exchange rates matter. An appreciated exchange rate puts competitive pressures on manufacturers to revitalize and improve productivity in their businesses. A depreciated exchange rate tends to protect manufacturers from foreign competition, and retards the pace of productivity improvement. The drop in the value of the Canadian dollar vis-à-vis U.S. dollar and other currencies in the late 1970s seems to have contributed to the relatively poor productivity performance of Canadian manufacturers.
- The post-1980 widening of the manufacturing gap seems to reflect the stimulative effect that a large worldwide appreciation of the U.S. dollar and increased profitability had on U.S. manufacturing productivity. Canada's depreciated dollar vis-à-vis the American during most of this period led to a slower rate of revitalization in Canada than might otherwise have occurred.
- This suggests that with the wider market offered under U.S./Canada free trade, relatively low energy prices and a stronger Canadian dollar, Canadian manufacturing productivity growth rates should outpace American rates and narrow the productivity gap.

Manufacturing productivity and gains from free trade

Historically, Canada has had a small domestic market protected by tariff and non-tariff barriers and, as a result, a great many Canadian manufacturing firms are relatively small. And smallness in turn, is accompanied by inefficient scale in the operation of the plants, short production runs, limited research and development budgets, and slow diffusion of technology. The author estimates that more than 70 per cent of plants in the Canadian manufacturing sector in 1987 were operating at a scale less than sufficient to compete successfully within a tariff-free North American market. Many firms will have to adjust, and restructure their operations so as to specialize production and take advantage of economies of scale.

If even half of them do this, Rao asserts that Canada-U.S. free trade could produce manufacturing productivity gains of about 4 per cent. These gains alone, he says, could increase real gross output and per capita income in Canada by about 2 per cent. But in the process, Canadian manufacturing firms will have to learn to use new workplace technology more rapidly and effectively, expand research and development to generate new products and services, and help in the encouragement of a flexible, motivated, and highly-skilled labour force.

"U.S.-Canada productivity gap, scale economies, and the gains from freer trade," by *P.S. Rao*. Discussion Paper No. 357.



Free trade could narrow the productivity gap between Canada and the United States

Regulating natural monopolies

Why has Canada adopted government enterprise more often than the United States to help regulate its industries?

In some cases, Crown corporations were viewed as the best instrument to meet specific objectives. But in a number of key instances they were established partly because of the inadequate protection given to property rights in Canada, according to a new research study done for the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3). In his study, Queen's University economics professor John R. Baldwin traces the evolution of the regulatory process and also compares it with the U.S. experience.

Baldwin looks, in particular, at the evolution of regulation in the utilities sector (water, gas, electricity, and transportation). He explains that regulation of utilities evolved partly out of the need to ensure that such public services would be adequately available at reasonable cost. Initially, a system of regulation developed whereby local governments issued franchise contracts to deliver those services. When tenders were first called for these contracts, municipalities generally had several bidders from which to choose. But when the contracts came up for renewal, the number of bidders declined. The franchise contract no longer worked in those circumstances.

Regulatory agents

In this environment, franchise owners could use their monopoly power to raise prices exorbitantly. Governments, on the other hand, could threaten to expropriate the business if that happened. What was needed was a regulatory agent that could function impartially to ensure that each party to the contract did not abuse its power, Baldwin explains.

In the United States, state regulatory commissions became the normal form of regulation.

In Canada, on the other hand, many utilities were nationalized. (Regulatory commissions were later established as well.) Baldwin attributes the more frequent choice of public enterprise in Canada to at least two factors. First, it could have been the result of a greater predilection for government enterprise. Second, it could have been the result of the lower cost of expropriation. In Canada, private property is not given the same protection from nationalization without confiscation as it is in the United States. Without the protection afforded by a written constitution that guaranteed the right to private property (as in the United States), there developed fewer judicial restrictions in Canada against confiscation of property.

Forced bankruptcy

In the railway industry, the government used contracts to stimulate construction of trans-Canada railway lines, with a regulatory body to control freight rates. That regulatory body, under the government's direction, contributed to the bankruptcy of some of the new transcontinental railways by failing to allow price increases that were commensurate with mounting costs. Additionally, when the government subsequently nationalized the Grand Trunk, it did not compensate the owners for the value of their stock (as it did in the case of the Canadian Northern). In Baldwin's view, this instance clearly demonstrates the "failure of the regulatory system to safeguard the interests of capital."





Ontario Hydro

As in the railway sector, the electric utility industry in Ontario was transformed by the creation of a large public enterprise. The provincial Crown corporation, Ontario Hydro, was established as a quasi-regulatory agency, which purchased power and then redistributed it for purchase by municipally owned systems. But it eventually became the dominant producer of hydro-power by purchasing various facilities. In so doing, the provincial government voided its original contractual obligation that prevented Ontario Hydro from competing in power generation with private interests.

Bell Canada

Bell Canada managed the evolution of the regulatory process to its own advantage, Baldwin explains. It quickly developed a monopoly grip on the telephone market by buying up its competitors and negotiating exclusive contracts with local governments. At the same time, it was able to avoid local regulation and possible expropriation (in central Canada) because it had been given a federal charter that superseded municipal and provincial government regulation. In Manitoba, however, the provincial government was intent on local control. It forced Bell to sell out by threatening to impose a discriminatory tax and then established a Crown corporation.

Baldwin examined the reasons behind the differences in the evolution of the regulatory process in various jurisdictions, including the impact of the political, economic, and social environments.

Regulatory Failure and Renewal: The Evolution of the Natural Monopoly Contract, by John R. Baldwin.

The local-development alternative

Council Deputy Chairman Caroline Pestieau spoke on the subject of local development at the Europe-North America International Conference held recently in Montreal which explored different aspects of local development. Following is an abbreviated version of that speech.

Canada is a laboratory where the local-development experiment has taken on particular importance. The second largest country in the world, it has a population of only 26 million. Approximately 9 million people live in the nation's three main urban centres, with the rest of the population spread out along a thin band some 5,500 kilometres long.

Economic and social indicators reveal large and persistent differences between the various regions of the country. In 1986, for example, unemployment rates ranged from 7 per cent in Ontario to 20 per cent in Newfoundland.

Most of the issues in local development arise from two fundamental questions. First, is it enough simply to distribute the benefits of national economic growth by means of compensatory transfers, or should we try to get growth going in individual communities across the country?

Second, assuming that it is important to diffuse economic growth throughout Canada, should people be moved to where the jobs are, or should jobs instead be brought to the people living in disadvantaged communities?

The federal government redistributes resources to economically disadvantaged regions in three ways. First, it makes unconditional transfers to provincial governments under the tax-equalization system, which enables the poorer provinces to offer national levels of public services without having to impose a higher tax burden than that in the better-off provinces. Second, it makes targeted transfers to cover expenses in health care, post-secondary education and income security. Third, it provides more generous unemployment insurance to unemployed individuals in regions with high unemployment rates.



Caroline Pestieau

Compensatory transfers have two weaknesses, however. First, because of the federal structure of the country, redistribution is largely carried out on a provincial basis. But the province may not be the most appropriate unit for tackling local underdevelopment.

Second – and more important – compensation through transfers does not encourage local development. It can even work against it by encouraging residents of disadvantaged communities to accustom themselves to dependency on the public purse.

Regional development

Since the early 1960s, Canadian governments have adopted a series of regional development policies to stimulate economic activity in the disadvantaged regions. These have had limited success and are currently under review. But it will not be easy to improve our national regional development policies. The slackening demand for Canada's natural resources means that the economy must become more competitive. It can no longer afford the luxury of subsidizing inefficient businesses or industries in various regions.

To sum up, there are several compelling reasons to investigate an alternative approach to regional development:

- The drawbacks of relying exclusively on compensatory policies,
- The difficulties involved in spreading economic growth by means of centralized policies,
- Fiscal and contractual constraints on industrial subsidization.

That alternative is local development.

Local development

Local development offers a third option for victims of regional economic decline, who are otherwise forced to choose between remaining in their communities as social assistance recipients or moving to the city to find work. That is the reason why the Economic Council decided to study the local-development experience in Canada. In the course of two years, we undertook 14 different case studies across the country.

Our research reveals a role for local-development organizations (or LDOs).

- They mobilize underemployed and "discouraged" workers.
- They identify the obstacles to economic development.
- They set their own objectives.
- They serve as catalysts for local enterprises particularly by helping them to access capital.
- By taking control of the development process, they maximize the spin-off effects and set the pace of growth to the needs of the local community.

In all of these respects, LDOs may do a better job than public or private sector managers from outside the community. But our work also shows that there are problems in giving public support to LDOs.

The main problem is how to rate the contribution they make to regional development. How can cost-benefit analysis be performed on subsidies awarded to LDOs? A second problem is the legitimacy of an LDO as opposed to that of a statutory organization such as a city council.

Overall, LDOs play, in many ways, the traditional role of the entrepreneur. They identify niches and business opportunities, and they coordinate the existing, though underutilized, resources of the local community. However, unlike the private entrepreneur, they ask society to share their risks. The challenge is to create efficient risk-sharing mechanisms.

Trade: Competitiveness is the key

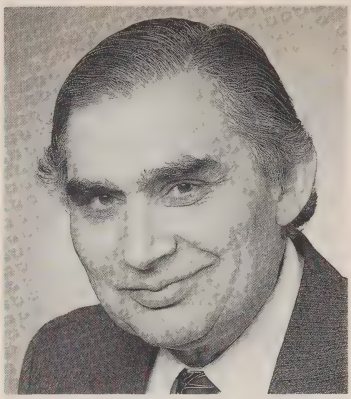
Competitiveness! That's an increasingly important issue as Canada seeks to improve its trading performance with its partners around the world.

As one of the major trading nations, Canada has high stakes in the trade liberalization process going on as a result of the recent Canada-U.S. Free-Trade Agreement or through the current Uruguay Round of multilateral trade negotiations. Opportunities to expand and diversify Canadian commercial relations with many countries are great but competition is also becoming a lot fiercer whether it originates from Japan, the United States, the European Community countries, and more recently from the Newly Industrialized Countries (NICs).

To meet these new challenges, with some measure of success, Canada must have a fairly good idea as to what are its strengths and weaknesses as well as its competitiveness with some of its trading partners.

The Economic Council of Canada will be trying to find answers to these questions by undertaking a new research project entitled "Canada's Trade Prospects and International Competitiveness."

This research project is unique. It will use a new World Trade Data Base, recently developed by Statistics Canada. It will analyze in detail, for the first time, the changing comparative advantage of Canada's exports and imports, by product or industry and by country during the period 1971 to 1986. The research will show who the competitors of Canada really are in various sectors of the world market and how they have evolved over time.



Sunder Magun

The study will also aim to develop various indicators of competitiveness according to the industry or to the trading partners with whom Canada is dealing.

To find out more about this new undertaking, *Au Courant* interviewed project director Sunder Magun.

Au Courant: *Why did the Council undertake this project?*

Magun: There are basically two reasons why the Council has undertaken this project. One, Canada is a trading nation. Future improvements in our standard of living critically depend on our ability, as a nation, to compete and sell in world markets. Therefore, it is essential, to start with, to examine our competitive position relative to our major trading partners. That means looking at the reasons for our current position and the trends in our trade with other countries. Secondly, our access to the global market is determined by the state-of-the-world trading system. Although the Canada-U.S. Free-Trade Agreement has improved our access to the market in the United States, we want to diversify and expand our trading relation with the developing and Pacific-Rim countries and with the European Community. Our share in trade in the Pacific-Rim countries is still small even though it has become a very high growth area. We also want to develop our trade and investment links with Japan and the Far-East Newly Industrialized Countries. Canada is actively involved in the liberalization process of the world trading system through the Uruguay Round of multilateral trade negotiations (GATT). The study we are undertaking will help us to understand the issues and options that are being discussed at the Uruguay Round and to improve our knowledge about the emerging trade and investment opportunities and challenges in the Pacific Region.

Au Courant: *What are the broad objectives of your research?*

Magun: We will analyze the evolution of Canadian trade patterns of the last 25 years. By doing so, we hope to develop various indicators of competitiveness whether by industry or by major trading partners. We will be looking at different economic aspects such as labour productivity, total factor productivity, unit total costs, unit labour costs, and finally technological growth. By trying to understand more about our trading relations with the Pacific-Rim countries and the developing countries, we will identify the obstacles to expansion and the barriers which certain countries are imposing on Canadian exports and ultimately find out how they influence our trading performance in various world markets.

Au Courant: *Which commodity sectors will the study concentrate on?*

Magun: We will be working from a new and very large, database produced by Statistics Canada containing trade information for about 160 countries and almost 600 commodity groups. Our analysis will, in fact, condense these commodity groups into 63 categories and 15 country blocks. We will also conduct a delailed analysis of our trade in high-tech products.

Au Courant: *Why this renewed interest in the Pacific-Rim countries?*

Magun: One of the main reasons is that this is the area where the future growth will take place. Investment is growing in this region and, on the other side of the coin, the flow of investment from this area to other countries is also increasing. Our trade with these countries is mainly concentrated in a few commodity groups like agriculture and mineral resources. The Pacific-Rim countries offer great possibilities for Canada in its effort to increase its share of global world trade.

Au Courant: *What about our strengths and weaknesses?*

Magun: There are a number of areas where Canadians fare rather well such as in the agricultural products, mineral resources, natural resource-based manufacturing commodities like paper

and paper products, motor vehicles, non-ferrous metals, etc. But I think we have to do more. We have to diversify our trade and expand in other manufacturing industries, particularly in the high-tech market which is growing rapidly in the industrialized and newly-industrialized countries.

> ***"The Pacific Rim countries offer great possibilities for Canada in its effort to increase its share of global world trade."***

Au Courant: Are there any particular countries with which Canadians will be competing to secure a bigger share of world markets?

Magun: The competition is very fierce all over the world. There are many countries that are competing with us in several markets. In the highly labour-intensive products, such as textiles and leather, Canada's competition comes from the newly industrialized countries such as South Korea, Hong Kong, Brazil, Taiwan, and Singapore. Canada faces strong competition from the United States, Japan, and the European Community countries in manufacturing products with high-skilled labour and capital content.

Au Courant: How can we consider your project in the context of the Free-Trade Agreement with the United States?

Magun: The Canada-U.S. Free-Trade Agreement provides us with a fairly safe market in the United States. By increasing our benefits from economies of scale and industry rationalization, the free-trade agreement will improve our competitiveness and consequently our ability to compete more effectively in other global markets. We must remember that certain issues have not been settled in the Canada-U.S. bilateral agreement. For example, the questions of intellectual property, government procurement, and subsidies have been postponed. They will be discussed in the multilateral trade negotiations. As part of our research program, we will look at these trade policy issues.

Au Courant: Currently what is Canada's share of the world global market?

Magun: Our share of world trade, and I am talking about export volume, has fluctuated with time. In the 1965-72 period, it increased from 3.7 to 4.2 per cent. From 1973 to 1980, our total export share averaged around 3.7 per cent. During the last four years, 1984-88, it rose to 4.4 per cent.

Au Courant: What would be a realistic objective for Canada for the next 25 years?

Magun: This question is very difficult to answer. It evidently depends upon future economic growth in Canada as well as in other countries. Although we should aim to improve our share in world exports, it would not be easy because of the intensity of the competition in the global market. Several less-developed countries are growing quickly and converging to the level of industrialization already attained by the major industrialized countries. Because of stronger competition emerging from the NICs, Canada may find it hard to even sustain its relative position in world trade. However, Canada's absolute level of exports would increase because of the growing size of the world economy during the nineties. There is, of course, another way of improving our international competitiveness and standard of living. Rather than increasing its share in world trade, Canada could improve its competitiveness by moving up the value-added scale in its export specialization. This approach is being used by Japan and other industrialized countries.



Canada's share of world markets critically depends on its ability to compete with its trading partners around the world

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NEW STAFFING PROGRAMS FOR RESEARCHERS

To commemorate its Twenty-Fifth Anniversary, the Economic Council of Canada has launched two programs designed to provide researchers and highly qualified Ph.D. students with an opportunity to work, for a fixed term, with Council research staff on a variety of projects.

The first program provides a Ph.D. student whose thesis topic is relevant to the Council's research program with an opportunity to write his/her dissertation at the Council. The student will receive an assignment lasting up to two years with the possibility of a one-year extension in certain cases. The Council offers two positions of this kind.

The second program comprises two options. The first option, involving a term not to exceed one year, is aimed at professors planning sabbatical leave in order to pursue their research or to undertake new projects. The second option, involving a term of at most two years, is open to professors taking leave without pay, to public service professionals, to researchers from other institutions, and to other individuals with appropriate qualifications. The incumbent's responsibilities will combine research work with the provision of advice and counsel to senior management at the Council. One position is available for each of these two options.

Brochures describing each of these programs have been sent to universities and to most research centres across Canada. Candidates interested in obtaining additional information are invited to contact Mr. Jac-André Boulet, Coordinator for Institutional Relations, Economic Council of Canada, Post Office Box 527, Ottawa, Ontario K1P 5V6; telephone (613) 952-1715.

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INTERNATIONAL FINANCE
A New Frontier



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- Research and the "power of ideas"
- Grain exports: Canada's vulnerability
- Immigration: Cost and benefits

PUBLICATIONS

Council Report

A New Frontier (EC22-160/1989E; $5.95 in Canada, US$7.15 elsewhere).

The world of finance is changing at unprecedented speed. New technology, new services, and new approaches to regulation have created a climate for explosive growth in international financial markets. How are Canadian borrowers and lenders faring in these competitive financial markets? This policy statement by the Economic Council of Canada gives some answers and proposes policies to improve the Canadian financial system. The document describes how international financial markets have been transformed in recent years. It discusses new financial services and notes that new technology is binding the financial world into a single global marketplace. Turning to the domestic scene, it deals with such issues as the competitiveness of Canadian financial institutions internationally and the impact of new services on Canadian markets. The Council's policy proposals are designed to strengthen competitiveness and to improve supervision of financial firms.

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than to the Council.

Canadian Agricultural Policy and Prairie Agriculture, by Murray Fulton, Ken Rosaasen and Andrew Schmitz (EC22-159/1988E; $11.95 in Canada, US$14.35 elsewhere).

This study examines the crisis of Prairie agriculture in the 1980s with particular attention to the build-up of farm debt which has been one of the distinguishing features of the recent crisis. It identifies the volatility of land values as a key element in the transition from the booming years of the late 1970s to the bust in the mid-1980s.

The authors then review the major programs the federal government has used in recent years to support Prairie grain farmers. Programs examined include: subsidies under the Western Grain Transportation Act, the Western Grain Stabilization Program, crop insurance, agricultural credit, the Special Canadian Grains Program, and the two-price wheat system. The study investigates the role these programs played in aggravating and in alleviating the crises and looks at their overall effects on the Prairie farm sector.

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the sole responsibility of the author, or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 361 "General equilibrium models in the development of social policy," by *A. Pierre Cloutier* and *Bernard Fortin*.

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion papers, *Au Courant* and the *Annual Report* are available without charge from the Publications Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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Globalization and financial innovation

A new frontier to conquer

Since the early 1980s, international financial markets have experienced an unprecedented expansion which, through its magnitude and scope, will permanently transform the way business is conducted domestically and internationally.

Governments, regulatory authorities, financial institutions, and businesses of all kinds are scrambling to adapt to the new financial frontier where national boundaries no longer stand in the way. This is the phenomenon known as internationalization of financial markets.

Fuelled by telecommunications high technology, financial internationalization has given rise to, among other things, a wide array of new financial instruments.

Those able to adapt rapidly to the new financial environment and to take advantage of its opportunities and avoid its pitfalls will quickly move to the head of the pack. Those reluctant to do so will inevitably find their markets slipping into the hands of bolder competitors.

These profound changes offer a wealth of possibilities for making business gains and tapping new financing sources. There is no doubt, however, that internationalization and innovation necessarily involve risks. Market "transparency" has, in fact, been reduced.

The challenge is thus to discover and learn how to use the new financial instruments while minimizing their inherent risks. A balance must be struck between, on the one hand, the competition and accessibility offered by the new financial environment and, on the other, the guarantees of solvency and reliability offered by appropriate solvency standards in law and sound corporate management. There is no denying, however, that increased competition inevitably entails greater risks.

Canada cannot ignore the recent evolution. This is the challenge laid out by the Economic Council of Canada in its Statement on international finance, the fruit of some two years of research. Convinced that internationalization offers exciting opportunities for the country, the Council's document begins by retracing in detail the transformations of the last few years and ends with a series of recommendations designed to help Canada take advantage of the new opportunities while avoiding the inherent risks.

One thing is certain, stresses the Council: the worldwide trend in favour of integrated financial markets is now irreversible.

The Council notes that Canadian financial institutions have been losing ground internationally. And this loss of ground – a potential source of concern – comes just as the European Economic Community is poised to achieve full market integration. In 1992, the 320 million residents of the EEC will become members of a single market within which individuals, goods, services, and capital will be able to move almost as freely as they do within their respective nations today.

Competitiveness is the order of the day. To retain a foothold in this difficult environment, the Council asserts, Canada must opt for competition over protectionism.

Among other topics, the Council's Statement focuses on the following areas:

- *Harmonization of Canadian regulation* — According to the Council, one of the first steps has to be to put Canada's own regulatory house in order. Both greater harmonization and closer cooperation between the various regulatory authorities are required.
- *Investment abroad by pension plans* — The Council recommends that the Income Tax Act be amended to gradually remove the limits on investment abroad by pension funds.
- *Opening up Canadian markets to foreign institutions* — The Council comes out in favour of abolishing the barriers that now prevent Canadians from participating fully in international markets, and it proposes continued action to facilitate foreign institutions' access to Canadian markets.
- *New financial instruments* — The Council recommends amending the provincial and federal legislation governing financial institutions to explicitly allow for the use of new financial instruments – futures, options, swaps – within the "prudent investor" framework. It also suggests "securitization" as a possible means of assisting the development of regions and small and medium business in Canada.
- *Links between financial institutions and nonfinancial corporations* — The Council Statement discusses the kind of links that should be allowed between financial institutions and nonfinancial corporations, already a subject of lively debate. The Council argues in favour of fairly tight restrictions, with a view toward enhancing the institutions' solvency and market stability.
- *International cooperation* — To harness the forces unleashed by globalization of financial markets, greater cooperation at the international level will be required. The Council thus urges the Canadian government to actively promote greater cooperation within the international community so that the obstacles standing in the way of orderly progress towards globalization may be eliminated.
- The efficiency of financial markets should, in the view of the Council, be everyone's concern – consumers, homeowners, fledgling entrepreneurs, and chief executives of large corporations. The financial system, it notes, is the machinery through which funds are channelled from investors to borrowers and risks are transferred to those firms best able or most willing to take them on. The efficiency of the financial system affects the cost and use of money; as a result, it also affects the pace of industrial development, the value of the Canadian dollar, and, ultimately, the length of the "Help Wanted" section in our daily newspapers.

Thus, asserts the Council, an efficient financial system is the driving force behind a country's economic well-being.

Canadian institutions: Losing ground

Canadian institutions have operated in international financial markets since before Confederation. The Bank of Montreal opened for business in New York in 1859, in Chicago two years later, and in London nine years after that.

Canadians have also long been major investors and borrowers abroad. Many large nation-building projects, including the Canadian Pacific Railroad, were financed by foreign capital.

Today, however, Canadian institutions play a relatively small role on international markets. Worse, they are losing ground. Several indicators can be used to measure this phenomenon, including market share and asset size.

Globally, the share of Canadian institutions as managers of issues on the Eurobond market has declined from 6 per cent in 1976 to 2 per cent in 1988.

In terms of assets, the relative position of Canadian banks has weakened significantly. For example, the Royal Bank, ranked 16th in the world in 1981, had slipped to 57th position by 1987. Displacing it in the rankings over the past eight years were competitors from the United States, the United Kingdom, Japan, Switzerland, France, West Germany, Hong Kong, Italy, the Netherlands, Brazil and China.

While Canadian borrowers are very active on international markets, they make little use of domestic institutions to manage their foreign issues. The federal government itself has not called upon a Canadian institution to manage its foreign issues.

The Economic Council expresses surprise and concern about the decline of Canadian banks on international markets. From its many interviews with Canadian customers of Canadian banks and securities firms, as well as an extensive survey, a number of explanatory factors emerged: a certain lack of aggressiveness in pricing policy, less extensive worldwide networks than those built up by foreign rivals, insufficient access to investors, and strategies focused inward and oriented toward the short term.

Lying behind these explanations, notes the Council, is certainly the smaller size and capital of Canadian institutions compared to their major foreign competitors. But there are other factors that go beyond the size and efficiency of the Canadian institutions. One is that the pool of capital directly available to Canadian financial institutions in the form of domestic savings has shrunk

Canada's loss of ground on international markets is worrisome. If Canadian institutions continue to lose market share and to reduce their international operations, they may eventually find it difficult to retain their traditional Canadian customers in the face of competition from better-capitalized and more internationalized institutions.

Putting Canada's regulatory house in order

In Canada, the evolution of financial regulation reflects our divided constitutional power. The multiplicity of regulatory authorities has acted, at times, as a catalyst for change and has provided Canadians with an enriched system that serves their many different financial needs.

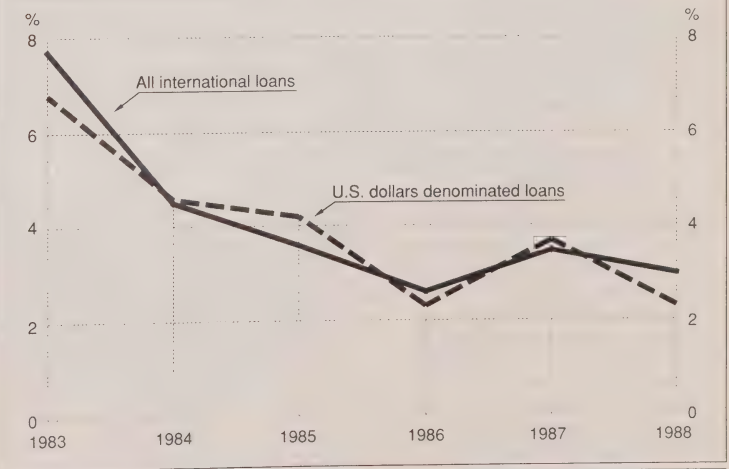
Canada's fragmented regulatory framework, however, creates problems in today's environment. Regulatory systems that compete across jurisdictional boundaries impose extra costs on financial institutions.

The number of foreign participants in the Canadian market has increased in recent years; Canadian-controlled firms have expanded their international activities; new financial instruments have proliferated. All of these developments have combined to reduce the transparency of the financial sector. To deal with these issues, the Council sees an urgent need to act quickly to harmonize regulation across the land and coordinate prudential supervision.

The lack of information-sharing between regulatory authorities and inadequate coordination of prudential supervision are, says the Council, major impediments to improving the efficiency of Canada's financial system. In delaying action on this front, Canadians are running counter to world trends. Regional economic blocks, especially Europe, are attuning themselves to the globalization of financial markets by harmonizing national regulatory and supervisory systems in the financial sector.

The Council puts forward two recommendations for the two key areas where

Share of Canadian Banks and Securities Firms as Managers of International Loans, 1983-88



increased compatibility is needed: regulation and prudential supervision. It urges the federal and provincial governments to work together on harmonizing such issues as investment powers, capital requirements, related-party transactions, and the distribution of financial products.

Secondly, the Council recommends that the federal and provincial governments coordinate the prudential supervision of Canadian financial institutions. It sees the simple sharing of information as only the first step in this process. Coordination must also extend to the standardization of norms for financial solvency, the development of early-warning systems, the level of capitalization, and the examination of financial firms.

To facilitate the implementation of these two recommendations, the Council advocates the creation of a formal organization of independent provincial and federal regulators, to include, amongst others, the federal Office of the Superintendent of Financial Institutions, the provincial securities commissions, and provincial regulators of financial institutions. This organization would have a permanent secretariat and possibly be assisted by specialized committees. It would remain the responsibility of the 11 governments to translate the agreement into law, and the responsibility of regulatory authorities to enforce the law within their own jurisdiction.

Links between financial institutions and nonfinancial corporations

By considering the issue of the ownership of financial institutions by nonfinancial corporations, the Council steps right into an ongoing controversy. Some are wholeheartedly in favour of commercial/financial links, while others are adamantly opposed.

Federal proposals put forward in 1987 would have the effect of tightening ownership restrictions for loan, trust, and insurance companies with capital in excess of $50 million. At the same time, the governments of Ontario and Quebec have been moving in the opposite direction – towards allowing the establishment of commercial/financial links. The government of British Columbia adopted a similar position in 1988.

Because there are strong arguments and counterarguments on both sides of this issue, notes the Council, it is not an easy matter to decide where the public interest lies. From the simple perspective of promoting competition and opening up markets, nonfinancial firms should be allowed to own financial institutions without any reservations. From the simple solvency perspective, commercial/financial links should be banned outright. The former approach would enhance the competitiveness of various financial institutions but would, at the same time, serve to weaken the long-term stability of the financial system. The latter would buttress solvency but stifle competition. A middle-of-the-road solution is needed.

While stressing that many of its other recommendations are aimed at increasing competition, the Council judges that, on the question of links between nonfinancial corporations and deposit-taking institutions (which enjoy the benefits of deposit insurance), it is preferable to give priority to the solvency of institutions and the stability of financial markets. The benefits of commercial/financial links can be obtained in other ways.

The Council recognizes that a number of provincial jurisdictions have indicated their support for commercial ownership of financial institutions. The Council feels, however, that a more long-term vision and a serious examination of the risks involved in such an approach are called for.

Realizing that links of this kind already exist between some institutions, the Council believes that such arrangements should be "grandfathered." Nevertheless, it feels that the commercial owners of financial firms should be required to gradually reduce their involvement to less-than-majority ownership.

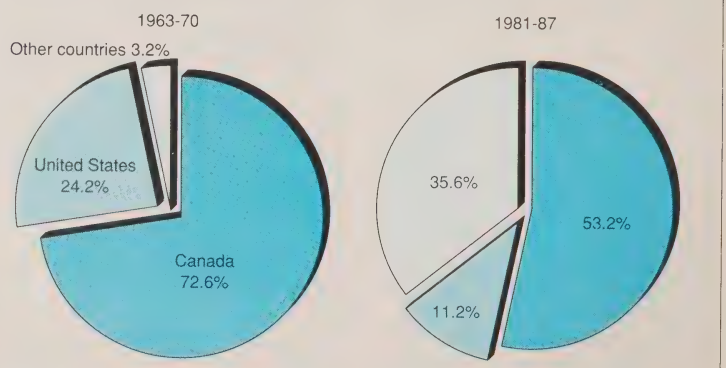
Securitization

Among the list of new financial instruments, the Council singles out the conversion of loans into securities. This involves pooling mortgage loans, automobile loans, commercial loans, and so on into a pool created especially for this purpose and the selling to investors of participation certificates (or shares) in the pool. This process is called "securitization."

In 1987, 30 per cent of outstanding residential mortgages in the United States were pooled into funds of this kind. In fact, the concept had first appeared in the United States in 1970, with the assistance of the U.S. government.

The Council regards this financial instrument as a potentially important tool for the development of regions, particularly for small and medium-sized business. It also can serve to bring together

Placement of Canadian Bonds, 1963-70 and 1981-87



international and retail markets. Securitization of business loans, should it prove feasible, would benefit the development of regions and businesses and would strengthen Canada's financial institutions by enabling them to use their capital base more efficiently.

There are several components to the securitization process: origination of loans, packaging in a pool, establishment of a trust, selling of shares in the pool, credit enhancement, monitoring, and development of a secondary market.

The Council recognizes the inherent difficulties in the securitization of business loans given their heterogeneity. It therefore believes that the government must play the role of a catalyst in order to get a securitization program off the ground. Because the Federal Business Development Bank already plays an important role in the business financing area, it is likely in the best position to undertake the development of a securitized business loans market.

Swaps

Financial innovation has spawned another instrument of efficiency that is particularly attractive to Canadians – swaps.

Swaps are essentially arbitraging instruments that allow market participants to take advantage of price differences between markets in order to make a profit or to lower their costs. Swapping is not only widely used, it is also, despite appearances to the contrary, a surprisingly simple technique. It is analogous to young boys and girls swapping cards depicting their favourite athletes. When they want a particular card, they do not check every box of cereal where such cards are found, but buy the first they find and then swap whatever card is inside with a friend who has the card they want.

Interest-rate and currency swaps operate in a similar fashion. A borrower or lender who wants an asset or liability with a particular interest-rate structure makes the best deal possible and then swaps the payments on his debt or investment with another borrower or lender. For example, a corporation that has obtained a fixed-term loan may assume the interest payment on a floating-rate loan secured by another firm while the latter takes responsibility for the payments on the fixed-term loan.

Interest-rate and currency swaps, which did not exist in 1980, exceeded $889 billion and $210 billion, respectively, by the end of 1987.

Investment abroad by pension plans

To facilitate the participation of all Canadians in the globalization of financial markets, the Council recommends the elimination of restrictions on Canadian financial institutions, and particularly the elimination of the tax disincentive for pension funds to investment abroad.

Under the Income Tax Act, trusteed pension plans and registered retirement savings plans face a punitive tax penalty if their investments in foreign securities exceed 10-per-cent of the book value of the investing firms' assets.

Pension plans are large and are important investors in corporate securities. At the end of 1986, trusteed pension plans altogether held shares worth a total of $25 billion – some 10 per cent of all shares held by Canadians and about 37 per cent of all shares held by Canadian corporations and institutional investors.

Canadian pension funds often experience difficulty in diversifying their equity portfolios with Canadian securities alone. The 10 per cent limit also imposes a cost on pension funds inasmuch as it makes it harder to obtain the highest possible rate of return. The restriction does relatively little to improve the financing of Canadian business, since corporations (and governments) likely to have dealings with pension funds already have access to international markets. The Council acknowledges that, in the short run, some borrowers, including the federal government, might be adversely affected by the removal of this provision.

In any event, notes the Council, the removal of the present restriction should be implemented in successive stages and be subject to regular review.

Thus it suggests that the limit be raised by 2 or 3 percentage points annually, that the impact of the change be assessed every year, and that a comprehensive review should be conducted by the Department of Finance when the ceiling has reached 20-25 per cent.

Entry of foreign institutions into Canadian markets

In order to maximize the benefits of internationalization, argues the Council, foreign institutions must be given access to Canadian markets. Their presence in Canada may add to the stability of the domestic financial system and provide a stimulus to competition and financial innovation.

The Council's Statement recommends that the right of establishment be granted to all foreign institutions in all segments of the financial industry and that they benefit from the same privileges and be subjected to the same obligations (national treatment) as Canadian-controlled firms, on the condition that Canadian institutions be given "national treatment" in the markets of the country of origin of the foreign institutions.

The Council also addresses the question of how foreign institutions should be allowed to operate in Canada – by branch or by subsidiary. This is another issue with important ramifications for the stability of the financial sector. While acknowledging that opinion on this topic is divided and that branches are less costly to set up and operate, the Council nevertheless opts for the subsidiary option for foreign financial institutions wishing to establish in Canada.

In the Council's view, until such time as supervision of the various kinds of financial institutions is better coordinated and regulation at the international level is harmonized, prudence would argue for the subsidiary option.

International banking centres

Another feature of the internationalization process that offers potential benefits for Canada is the booking of the international business of Canadian companies in Canada rather than abroad.

The Council notes that the place an international transaction is booked is often dictated by the taxation systems in place in the various countries (including, naturally, both taxes and exemptions). It is thus understandable that Canada has been attempting to match the financial

subsidies accorded by other countries in a bid to attract, or keep, this sort of activity. International Banking Centres (IBCs), which exempt the income from international operations from taxation, constitute just such a subsidy.

Parliament changed the Income Tax Act in 1987 in order to allow the designation of Vancouver and Montreal as International Banking Centres. As defined by the government, institutions in those two cities can accept deposits from, and make loans to, non-residents without paying federal tax on the profits from these transactions. Profits from investment dealing, letters of credit, and currency transactions, however, are still taxable. But the provincial governments have added their own concessions. For example, the Quebec government has gone one better than federal concessions by eliminating provincial taxes on capital gains, corporate profits, and employee income associated with international financial transactions taking place in Montreal.

The fact that IBCs are restricted to Vancouver and Montreal, notes the Council, may well result in business opportunities being lost. So far, little additional activity has been generated in Montreal or Vancouver. In the United States, on the other hand, there are no federal constraints on the location of international banking services.

Those who favour allowing these facilities to be established anywhere in the country argue that banks would set up IBCs where they would operate most efficiently; Canada would thus derive the greatest possible benefit. Since the international activities of Canadian banks are centred in Toronto, efficiency considerations would likely lead to IBCs being located in that city. In the United States, 80 per cent of banking centre assets are booked in New York City.

However, the Council recognizes that the establishment of IBCs in Montreal and Vancouver has a symbolic value in strengthening financial activities in those cities. Since we are dealing with a relatively recent phenomenon, concludes the Council, more time will be required before an adequate assessment of the efficiency of International Banking Centres is possible.

Reducing the risks

The Council sees closer international cooperation among the supervisors of financial institutions as an important way the risk of a financial accident may be reduced.

It notes that the securities industry in general has lagged behind the banking system in this regard. International coordination of prudential supervision of securities dealing is still in infancy. The banking sector started work in this area in 1970. The major landmark of this movement is the 1975 Basle Concordat on the sharing of prudential supervision, designed to maintain the solvency of institutions and to protect their clients. In 1988, an agreement was reached on risk-weighted capital requirements.

The International Organization of Securities Commissions (IOSCO) was set up in its present form in 1984. It has created a number of technical committees to work towards finding solutions to some of these problems. Although some progress has clearly been made, the Council sees a long road ahead.

A number of problems beg for closer international cooperation, failing which the world's financial system may be vulnerable to accidents in the securities area. The Council cites such issues as the transfer of information between regulatory institutions, the control of fraud, self-dealing and abuses of conflict-of-interest situations, as well as capital-adequacy standards.

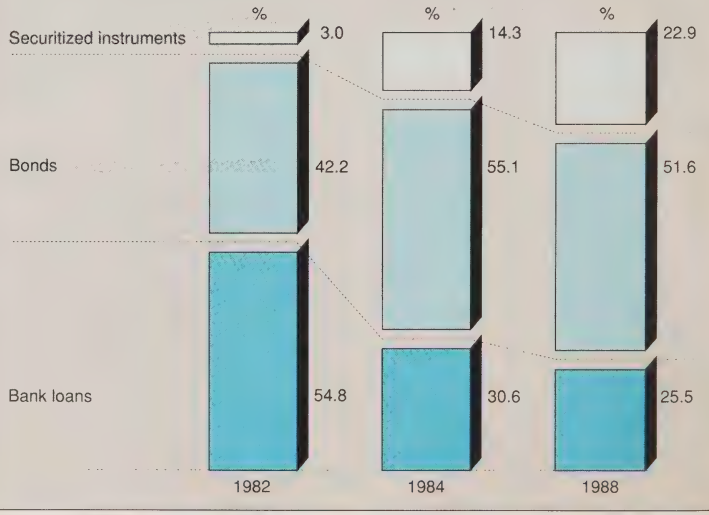
The Council also discusses the importance of achieving greater harmonization of accounting and auditing standards.

Summary

Despite a number of remaining barriers, the drive to globalization and financial innovation is now unstoppable. These forces, stress the Council, *embody a compelling combination of economic logic and ever-more-sophisticated technologies.*

The world of finance has already been fundamentally transformed by the influence of these forces – and there is no looking back.

Distribution of Funds Raised on International Markets, by Category of Instrument, 1982, 1984, and 1988



Securities
Harmonization is necessary

One of the major economic developments of the 1980s has been the internationalization of financial markets.

This new global economy raises some important concerns: notably, differences in regulation systems, accounting standards, and compensation systems; the prudential supervision of multinational financial institutions; and the stability of financial systems throughout the world. Solving these problems will require international cooperation among the various supervisory authorities. It was with this goal in mind that the recently formed International Organization of Securities Commissions (IOSCO), with its secretariat in Montreal, has undertaken to promote better coordination of international regulations.

Mr. Paul Guy, the President of Quebec's *Commission des valeurs mobilières* and the General Secretary of IOSCO, was recently invited by the Economic Council of Canada to present a seminar on the problems involved in the growing internationalization of securities trading and on the urgent need for international cooperation in this area. *Au Courant* is pleased to present a summary of Mr. Guy's remarks.

Internationalization of the securities industry

In light of the increasing internationalization of the securities industry, there is an urgent need for better coordination of regulations governing these activities, as well as sustained cooperation among various countries in order to ensure adequate prudential supervision.

This was the driving force behind the creation, in 1986, of the International Organization of Securities Commissions (IOSCO) in its present form. IOSCO now includes representatives from some 50 different countries. It has formed a technical committee to study some of the problems related to the internationalization of markets, which in turn has set up a number of expert task forces to study these problems and propose solutions. In his presentation at a seminar organized by the Economic Council of Canada, Mr. Paul Guy, the General Secretary of IOSCO, listed the main mandates of these groups: multinational security issues, the capital structure of securities firms, offshore markets, accounting and auditing standards, compensation and international regulations, and fraudulent activities.

Barriers to international security issues hamper the internationalization of financial markets. As Mr. Guy noted, the stipulations governing such issues and the requirements for regulation publication of information on companies once stock has been issued vary greatly from one country to another.

Thus the first step in achieving better coordination of regulations, according to Mr. Guy, is to determine exactly what these differences are.

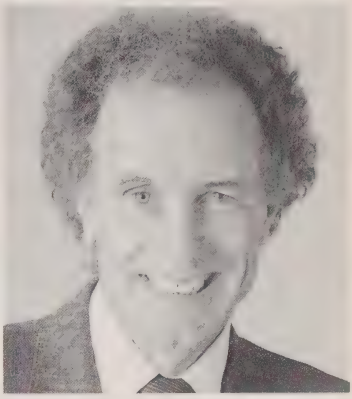
The difficulties involved in international issues are aggravated by the use of about 20 different sets of accounting standards worldwide.

For a number of years now, international organizations have been struggling with the task of developing a set of international accounting rules for corporate balance sheets and income-expenditure statements.

The imposition of minimum capitalization standards will serve to reduce the risks assumed by institutions and will come to be an important component of the supervisory process. Agreement has already been reached among a number of industrialized countries on minimum standards of risk in the banking sector. No such international consensus has yet emerged for the securities industry, however. Therefore, according to the IOSCO General Secretary, it is essential to develop standards not only for securities firms, but also for the other institutions, such as banks, that are becoming increasingly active in securities markets.

According to Mr. Guy, the fight against fraudulent transactions has been singled out for special attention by one of the IOSCO Technical Committee task forces. How to handle insider trading is becoming an increasingly important issue internationally. Mr. Guy believes that the best way to combat potential fraud is to set up special mechanisms to deal with cases of cross-border fraud.

Compensation and regulatory systems are also a source of concern to those involved in investment dealing. In North America, for instance, stock-market transactions are carried out within five



Paul Guy

business days. In other countries, they may take much longer to complete. Thanks to new technologies, it will soon be possible to finalize such transactions in less than a day. Until a transaction is completed, there is always a risk that the parties to a transaction might renegade on their commitments; thus the time factor is crucial. The first step is for all countries to set up efficient compensation and regulation systems. Once this is done, the links between the various systems can then be established.

Mr. Guy pointed out that the agenda on international cooperation in securities dealing is very crowded, and so (as is usually the case when extensive international negotiations are involved) progress tends to be slow. He stressed that, despite the urgency of the situation, one cannot expect miracles. While the stock-market crash of October 1987 has so far not had any catastrophic repercussions, it still forcefully underlines the new risks inherent in a global economy and the benefits that will come from greater international cooperation.

Europe is rapidly moving towards unification of its financial markets. Thus it is extremely important, according to Mr. Guy, to make sure that the direction taken by this block in terms of investment dealing does not conflict with the rest of the international community.

Mr. Guy's conclusion? The members of the International Organization of Securities Commissions have quite a job ahead of them.

Research and the "power of ideas"

As Judith Maxwell begins the second half of her term as Chairman of the Economic Council of Canada, she has agreed to review the first three and one-half years as well as to map out the Council's future directions as it prepares to enter the 1990s. As economic issues increasingly spill over into other areas, the Chairman sees many challenges ahead for the Council. She notes the important contribution that the Council can make through its research activities and emphasis on consensus – an approach that is helping decision makers and the public at large to rebuild the economic and social cohesion that has been so sorely tested during the 1980s. Mrs. Maxwell also stresses the quality of the "message" that the Economic Council must deliver to those responsible for charting the course of Canada's economic and social policy.

The Economic Council of Canada: Directions and Perspectives

Somewhat like an air traffic controller at a large metropolitan airport, the Council must look as far ahead as possible in order to anticipate the difficulties and challenges that lie over Canada's economic horizon. It must weigh all the factors involved in order to determine the best flight plan for the well-being of Canadians.

For Judith Maxwell, now beginning the second half of her term as Economic Council Chairman, that is as far as the analogy goes, however. Unlike an air traffic controller, the Council does not have the final say (or even a privileged say) in the dialogue with those responsible for setting the course of Canada's economic policies.

"In this context, the form of the Council's message becomes almost as crucial as the content," the Chairman observes, "all the more so because of the large number of parties simultaneously clamouring for the attention of today's policy makers."

Mrs. Maxwell points out that basic research remains the cornerstone of the Council's work. While the complexities of the modern economic environment demand that research projects be as exhaustive and rigorous as ever, she intends to focus on improving the quality of the message while maintaining the high standard of the Council's primary research during the second half of her term. The message, she says, "must be easily recognized and understood."

When it was established 25 years ago, the Council enjoyed a virtual monopoly on economic policy research. Today, decision makers are inundated with information and must be able to grasp rapidly and accurately the essence of economic policy advice and its relevance to their preoccupations.

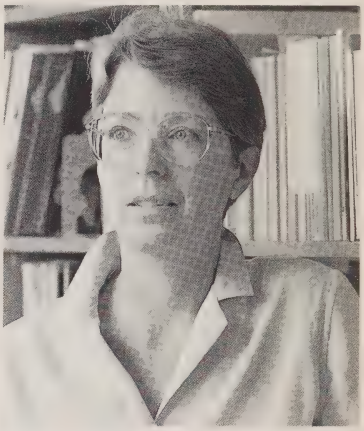
The Power of Ideas

Looking back on her three and one-half years as Council Chairman, Mrs. Maxwell notes one phenomenon that stands out: the "power of ideas."

"It is fascinating to follow the development of an idea and to realize the contribution it can eventually make to policy making, perhaps even to shaping public opinion. In essence, the Council is a generator of ideas." For example, the Council's emphasis on the importance of consultation and training in making successful use of new technologies has altered the way many Canadians think about technological change.

The Council, notes Mrs. Maxwell, has two major roles: creating a body of "economic know-how" through the work of specialized research teams and, equally important, using this knowledge to achieve a consensus that can help guide Canadians as they choose among the options available to them.

Canada's economic environment has changed radically since the Council was formed in 1963. Mrs. Maxwell singles out as an example the turbulence of the 1980s, produced by the combined effects of an unexpectedly severe recession, the shift from a resource- to a service-based economy, the rapid expansion of urban centres at the expense of rural areas, the polarization of opinion among economic advisers, changes in the ethnic mix and age profile of the population, and the growing importance of issues (such as social programs, health and education) where provinces have, or share with the federal government, a controlling jurisdictional interest.



Financial Times

Judith Maxwell
Chairman

In addition to these contentious issues, Mrs. Maxwell notes important international factors: the increasing globalization of the economy and of financial markets (a question addressed in a recently released Statement by the Council, discussed elsewhere in this issue); and the emergence of new economic powers, such as the Pacific Rim countries.

The combined result of all of these factors is that governments must make increasingly difficult choices at a time when the country is most in need of coherent policy approaches to a multitude of issues.

"The Economic Council can never claim to have all the answers to this extraordinarily complex jigsaw puzzle, but it is certainly in a position to make a valuable contribution to the process through its ability to generate new ideas," the Chairman believes. And that is exactly the challenge that Mrs. Maxwell and her team will attempt to meet in the final years of her term.

Specifically, the Council will bring its expertise to bear upon projects that squarely address some of the problems that tend to create divisions within Canadian society. The ultimate aim of this effort is to stake out the common ground where governments can make judicious policy decisions that citizens can understand and support.

A Unique Aspect

The Council certainly devotes a great deal of effort to basic research, especially data collection, sorting, and analysis. But, adds Mrs. Maxwell, "we must also endeavour to understand how governments work, how the regulatory system and our various institutions operate, and how our industries and communities have organized themselves to deal with their problems." This extra dimension of policy analysis is essential if the Council's work is going to be both pertinent and well-understood.

"It is fascinating to follow the development of an idea and to realize the contribution it can eventually make to policy making, perhaps even to shaping public opinion."

The Chairman finds the contribution of the Council's members to this process extremely valuable. The task of these individuals, who represent the various regions and economic interests of the country, is to review and discuss the results of the economists' work in order to arrive at a consensus position on the Council's recommendations before the final product is delivered to decision makers and the public at large. The quest for consensus is one of the Council's outstanding features and ensures the uniqueness of its contribution to government program development.

"Message Received!"

Mrs. Maxwell is particularly proud of the performance of the Council as a whole in the last few years. It has succeeded in carving a place for itself in an extremely competitive environment, despite budget cutbacks that have led to a 10-per-cent reduction in its research staff and its operating budget.

Experience has shown that the Council's "message" is being received loud and clear. Its advice is now being sought out by both federal and provincial agencies – a sure sign of its pertinence. On a number of issues, Mrs. Maxwell notes, the Council's approach has become a benchmark. She points to the Council's findings on the impact of technology on labour markets, which have been adopted as basic analytical tools by both the federal and provincial governments. The same is true of the Council's thorough examination of the potential impact of the free-trade agreement. Even more recently, the Council's Statement on Prairie agriculture has helped to influence public opinion in that area, with its advocacy of assistance based on income rather than on production. In fact, Mrs. Maxwell considers this an excellent example of how an existing idea, researched, tested, and communicated by the Council, can make a contribution to the development of public policy.

"The Economic Council can never claim to have all the answers to this extraordinarily complex jigsaw puzzle, but it is certainly in a position to make a valuable contribution to the process through its ability to generate new ideas."

Projects

The agenda for Mrs. Maxwell's next half-term is particularly full. The Council will be looking at a number of issues where Canadians have some difficult choices to make. Several of these issues range beyond purely economic considerations and so will require multidisciplinary teams.

In the fall, the Council will publish its *Annual Review*, this year focusing on intergenerational equity. Mrs. Maxwell notes that this theme will draw upon the Council's research into the economy's potential for long-term growth, Canada's aging population, and the growing concern for the environment – "all issues that will form part of our legacy to the next generation," she points out.

The Council will also focus on labour market policy. A Statement on employment in the service economy will be published, assessing the impact in such areas as income distribution and job quality. In addition, Council experts will complete two other major studies – one on poverty and social policy in Canada, and the other on immigration (see interview, pages 14-15). Finally, the Council is considering a new research initiative on economic relations between Canada and the Pacific Rim countries.

Canada is vulnerable in world markets

Canada is one of the most vulnerable countries in the world to developments in the extremely volatile world grain market.

With 75 per cent of its production destined for export, Canada is more dependent on foreign trade than its major competitors, and so has more to lose from the chronic instability and uncertainty that currently plague the world grain market. Consequently, the nature and structure of this market has a major impact on the prosperity of Prairie grain farmers.

In recent years, national policies have become increasingly interdependent around the globe. The effectiveness of farm programs in one country now depends more than ever on the prevailing policies of others. A desire to protect themselves against the see-saw fluctuations of world markets has led a number of countries to institute programs and policies to subsidize production and exports. The result has often been that price instability is simply exported from one country to another. Retaining one's market share has become a matter of national pride; what seems to have been forgotten is that it is impossible for all players to increase their market shares simultaneously.

The tendency to resort to unilateral policies in perpetual reaction and counter-reaction to the actions of other countries can only strengthen protectionism and generate a more hostile business climate. In 1984, existing trade barriers throughout the world cost Canadian farmers about US$300 million.

In a study carried out for the Economic Council of Canada, Colin Carter, Alex F. McCalla (University of California, Davis), and Andrew Schmitz (University of California, Berkeley) stress how important it is for decision makers to understand that demand for grain in international markets is not elastic; i.e., it does not react strongly to price changes. At the most, changing prices may lead to a repartitioning of the market among the various producing countries. The three researchers state categorically that market instability is on the rise, not because of such traditional factors as climate and natural disasters, but because of shocks produced by particular policies.

The study's three authors believe that Canada has little to gain from a price war (which can only benefit importing countries), but much to gain from a worldwide reduction in tariff barriers. They acknowledge, however, that freer trade will produce both winners and losers. Eastern Canada's farm industry, for instance, is unlikely to champion trade liberalization. But, for Canadian Prairie farmers, far fewer options are available than for their counterparts in competing countries.

It is for good reason, according to the authors, that Canada feels caught in a situation not of its own making and about which it can do little without the cooperation of others.

Recent moves towards trade liberalization, including the Canada-U.S. Free-Trade Agreement, give some reason for hope, but the authors are quick to put a damper on unwarranted optimism. According to present indications, they say, both optimistic and pessimistic scenarios regarding future developments in grain markets remain equally plausible.

If liberalization falters, Canada could still pursue long-term bilateral agreements. This would not solve the price-war problem, however, since Canada would still have to compete with the United States, whose exports are subsidized.

In short, Canada has little choice but to support cooperative and multilateral approaches, and so must adopt farm strategies that are flexible and that keep its options open.

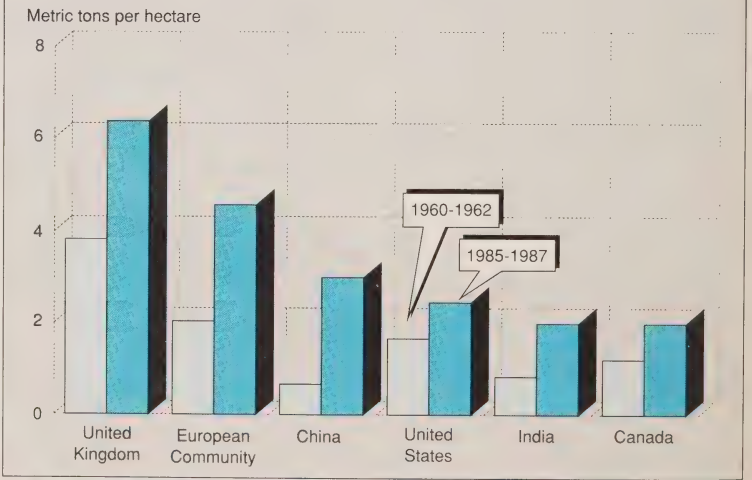
As far as government policies are concerned, the authors urge governments to strive to create an economic environment conducive to development while safeguarding their capacity to come to the aid of farmers should events take a turn for the worse.

Major structural change

The phenomenal increase in grain production in the European Economic Community is without a doubt the most striking structural change in world grain markets of the last 30 years.

Even though its cultivated area of 35 million hectares has hardly changed, the EEC has managed to double its grain production. From the largest grain importer and Canada's main customer during the 1950s and 1960s, the EEC has moved to become the third largest grain exporter in the world.

Wheat Yields in Selected Countries, 1960-62 and 1985-87



China and India have also made spectacular gains in yields. In 1960, these countries produced 0.77 and 0.78 tonne of wheat per hectare, respectively. By 1985, India's output had more than doubled and China's more than tripled to 1.81 and 2.93 t/ha, respectively. The authors point out that if it is possible for India to attain self-sufficiency through appropriate support policies and modernization programs, a number of other developing countries should be in a position to do likewise.

The United States, for its part, succeeded in increasing production by 55 per cent over the same period.

Between 1960 and 1985, Canadian grain production increased 25 per cent, from 1.42 tonne per hectare to 1.74. Fourth in terms of yield per hectare in 1960, Canada slipped to sixth place by 1985 – actually ranking below the world average. Output, it must be remembered, can vary a great deal from one year to the next. Canada's share of world production has generally remained around 20 per cent.

Particularly because of the EEC's excellent performance, Canada's exports to developed countries have fallen sharply, from 48 per cent in 1969 to 27 per cent in 1983. Canada recouped some of these losses through increased sales to countries with centrally planned economies, which jumped from 33 to 49 per cent over the same period.

The EEC has been steadily increasing its share of the world export market. In 1985, it accounted for 15 per cent, just 3 per cent lower than Canada. The extent of this turnaround is illustrated by the fact that the EEC managed to transform itself from an importer of 10.3 million tonnes of wheat in 1960 to an exporter of 14.2 million tonnes in 1985. It now has a major impact on international markets.

Japan

The import-demand prospects for the Chinese and Soviet markets present an enigma for the Canadian Prairie economy. The Soviet Union has always represented an unstable market, while China, at once the world's largest grain producer and one of Canada's most important customers, has set its sights on grain self-sufficiency.

Clearly, then, Japan, the world's largest net importer of food, represents an extremely attractive market for Canadian grain.

While Canada is already one of Japan's most important suppliers, it has to cope with a remarkably stringent system of tariff barriers that serves to restrict transaction volumes.

The retail prices of food in Japan are much higher than world prices. The retail price of rice, for instance, is double that in the United States. Beef is eight times more expensive and pork three times more expensive than in the United States.

Japanese government agencies buy food products at prevailing world prices, but then put them on the domestic market at much higher prices. The profits from this arrangement are channelled into farm subsidy programs.

In 1987, the Japanese government realized profits of approximately $1.6 billion on wheat imports alone. Japanese farmers thus enjoy a strong protective umbrella, probably the most extensive in the world. The fact that the world wheat price is set by the United States, point out the authors, explains why the 1985 U.S. *Farm Bill*, which has allowed the authorities to set target domestic prices and loan rates for farm commodities, has had such an important impact.

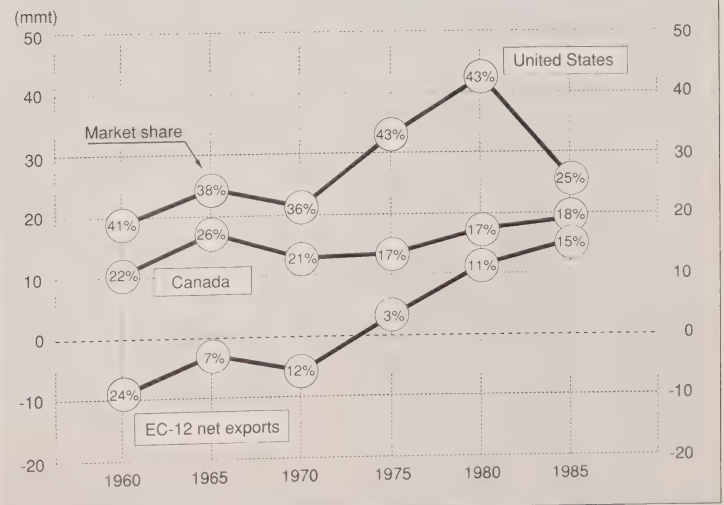
In order to remain competitive, Canada, too, must lower its export prices. The big winner in this game, of course, is Japan.

For every $1 per bushel reduction in prices, the Japanese Food Agency pockets about US$200 million, and Canada loses approximately $45 million.

It goes without saying that freer trade with Japan, whether through a bilateral agreement or under the terms of GATT, will be of greater benefit to Canadian than to U.S. producers. The way things now stand – with the quota system for beef imports, the preferential treatment for corn feed over barley, and the JFA's wheat import system – is to the advantage of U.S. producers.

The conclusion of the Carter, McCalla and Schmitz study? Freer trade with Japan is what Canada needs in order to increase its market shares for these three products.

World Trade in Wheat and Its Major Exporters, 1960-85



Measuring costs and benefits

Canada's birthrate is falling and its population growing older. According to demographic experts, the country's population will peak around the year 2030, then start to decline. Should we revise our immigration policy to compensate for this trend? That is the crucial question we must address.

Public pressure is growing for Canada to adopt a more open attitude towards immigration, particularly for immigrants from the Third World. Many Canadians are calling for more of an open-door policy, not just for refugees but also for ordinary people seeking better lives for themselves and their families.

The question of whether, in response to either of these trends, the pace of immigration should be allowed to rise in the next 10 or 20 years has become urgent. It is a complex issue, however. Immigration has a ripple effect that spreads to all corners of Canadian society. Not only are the questions many and complicated, they are often emotionally charged. Does immigration has an effect on the Canadian economy? If so, to what extent and in what way? What is the impact of the arrival of new immigrants on employment, urban development, social programs, governmental jurisdiction, cultural identity, or the economy as a whole?

In an attempt to find answers to these important questions, the Economic Council of Canada has undertaken a research project on immigration. The results, which should be available towards the end of 1990, are expected to be controversial. The Council believes, however, that to ignore an issue of this importance would be a far worse mistake.

A multidisciplinary team of experts will attempt to measure the impact of immigration on Canadian society as a whole. The team will try to debunk some of the myths that abound on this subject, in order to draw useful conclusions and formulate pertinent recommendations.

The task is a challenging one, for not all dimensions of this sensitive issue can be reduced to simple terms. To find out more about the Council's project, *Au Courant* interviewed its research director, Senior Economist Neil Swan.

Au Courant: *Will you be working exclusively from data already available or will you be undertaking some basic research of your own?*

Swan: We will make use of existing data, certainly, but we will also be doing some research ourselves. We will be using immigration data from the 1981 and 1986 censuses, and we will also be performing a number of special tabulations on these data. We will work closely with Employment and Immigration Canada and the Institute for Research on Public Policy in order to develop a longitudinal data base. This will enable us, among other things, to follow immigrants from the moment of their arrival in Canada, in order to find out how well they do out in terms of income and jobs, of their involvement in the business world, and so on. Ideally, the research could also be carried out for a small group of Canadian-born residents with similar profiles for comparison purposes.

Au Courant: *Will studies of immigration done in other countries be useful to your work?*

Swan: Naturally, we don't want to reinvent the wheel. There have been many studies on the topic of immigration elsewhere, and we will want to see whether their conclusions are in line with ours. In certain cases, we would like to pursue research in more depth. There have been some Canadian studies on the economic impact of immigration. While some of the foreign studies are certainly relevant to our project, we must take into account the many differences from one country to another. The United States, for instance, receives many immigrants from Mexico and Latin America. Some of these individuals enter the country illegally. Within the American population itself, there is a large black minority, as well as a sizable Hispanic minority. The position of the United States, therefore, is very different from our own, making it difficult to make comparisons. These same is true, to varying extents, for Great Britain and Europe in general. They are all distinct societies, with immigration traditions that differ from our own. One study that should prove useful, however, is the one recently completed on immigration into Australia.



Neil Swan
Research director

Other foreign studies on the social character of immigration may also prove helpful.

Au Courant: *Does immigration have any impact on the standard of living of Canadians? If so, in what way?*

Swan: This important question will be explored in a sub-project of the main study. It is quite possible, of course, that the level of immigration does affect our living standards, although opinion on this subject is clearly divided. Some claim that higher immigration bolsters the standard of living; other claim the opposite. It may be that immigration levels affect not only our standard of living but also the rate at which it changes. We hope to be able to measure changes in the standard of living, but measuring the pace of change may prove impossible.

Au Courant: *Part of the controversy surrounding immigration involves the question of jobs. Will you be looking at this issue?*

Swan: Yes, we hope to determine whether higher immigration has an effect, either temporarily or permanently, on employment. Does immigra-

tion create jobs, eliminate jobs, or is it employment-neutral? We will also try to find out whether certain groups are put at a disadvantage by immigration, in terms of jobs or income.

Au Courant: *How do you intend to differentiate between the economic and social aspects of immigration?*

Swan: Immigration clearly has an economic dimension, but its scope goes far beyond economics. The economic dimension may not even be the most important. The existing literature suggests that the effect of immigration on the economic welfare of Canadians themselves is probably not very significant, certainly not enough to warrant it being a major factor in determining how many immigrants Canada will eventually decide to accept.

The social dimension of immigration is much more important but lends itself much less readily to measurement, as it involves relationships between various groups in Canadian society. It is much more difficult to measure the advantages, disadvantages, or even the lack of change involved in various scenarios, such as those created by fixing immigration ceiling at 100,000, 200,000 or even 300,000 persons.

Because the social dimension is crucial, we will be calling upon the services of a group of experts from many different disciplines. We have already secured the services of a sociologist who will be coordinating research in the non-economic areas of our project.

Au Courant: *Is it possible to predict what changes will take place in immigration patterns?*

Swan: In the years to come, the traditional make-up of immigration will change a great deal. Because of the growing desire of people in Asia, India and Africa to emigrate, the face of immigration into this country will become much more visible. Again, the advantages and disadvantages of this phenomenon, as well as the possible reaction of Canadians to various immigration volumes, must all be explored.

Au Courant: *Will you be concentrating on certain specific immigration issues?*

Swan: The economic component of the project will attempt to focus on the consequences of immigration for Canadian-born residents, although we will also be looking at the situation of the immigrants themselves. We will attempt to determine how immigrants are integrated into Canadian society and to gauge the extent and nature of their contribution.

Au Courant: *What effect does immigration have on urban and regional development?*

Swan: As is well known, immigrants tend to settle primarily in the major metropolitan centres – Toronto, Vancouver, and Montreal. This means they favour just three provinces. This could become a significant factor if, as some authors advocate, immigration were to be seen as a way to compensate for Canada's declining birthrate. From this perspective, immigration in its current form might be viewed as contributing mainly to population increase in those three metropolitan areas.

Au Courant: *Will you be making a distinction between ordinary immigrants and refugees?*

Swan: I don't think we can ignore that aspect. How can we, as Canadians, decide how a given immigration quota should be allotted between ordinary immigrants and refugees? Is there a fair way to do it? Naturally, the Council doesn't want to become embroiled in the delicate issue of trying to judge who is a refugee; still, we cannot avoid the issue altogether.

Au Courant: *Will the aging of the population and the declining birthrate be important research topics in your project?*

Swan: The question of the "greying" population is important, in the sense that some people believe that immigration will alleviate the dependency problem that is normally associated with an aging population. Others disagree. We will take a look at both of these views. As for the declining birthrate, many people believe, of course, that it is one more good reason to investigate the implications of immigration.

Au Courant: *Do you intend to single out the province of Quebec for special attention in your project?*

Swan: The integration of immigrants into society is one of the major issues raised in the context of immigration. There are two opposing points of view. Should immigrants be allowed to maintain and promote their native cultures while adapting to Canadian society, contributing to the country's vast cultural mosaic? Or should immigration policy aim at integrating new Canadians into the dominant culture? Quebec's policy in this regard differs from that of English Canada, in that it strives to integrate immigrants into the Québécois culture. Assuming a substantial increase in immigration, it would be interesting to study the advantages and disadvantages of the two schools of thought. Such an exercise should prove enlightening. I don't know what the right answer is, but this is certainly the kind of question that the sociologists on our team will be studying.

"Quebec's policy in this regard differs from that of English Canada, in that it strives to integrate immigrants into the Québécois culture."

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Legacies



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- "Decoupled" aid programs for Prairie farmers
- Poverty: A new look at a social curse

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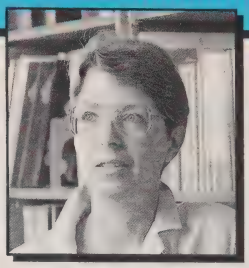
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Editor: Jean-Guy Bruneau

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Leaner legacies for our children



Judith Maxwell

Only humans have the capacity to imagine the future, and, within limits, to alter the future. In this year's *Annual Review*, the Economic Council looks at the legacies we are creating for future generations.

Traditionally, Canadians have presumed that technical progress would take care of the future – that continuing increases in productivity would ensure rising standards of living for today, and for future generations. We have also presumed that our resource base is so rich that we need not worry about depleting or degrading resource and environmental assets.

As it turns out, productivity growth has slowed dramatically in the past 15 years. Workers have so far felt the brunt of this slowdown, and many wives have compensated for falling real wages of their husbands by going out to work themselves. In general, we find that younger families have suffered more than older ones. In particular, younger families have been unable to accumulate savings, and because they are at the borrowing stage of their life, they have suffered more from high interest rates. Because incomes of many younger families have not been rising, there have been new claims placed on the social safety net.

Governments have been slower to adjust their behaviour. Slower productivity, and a weaker economy generally, have tended to raise expenditures (on Unemployment Insurance, for example), and to reduce revenues. This has led to a widening gap between federal revenues and expenditures, and the frightening accumulation of public debt at the federal level.

The message of this Review is that our traditional presumptions are off base. Unaccustomed as we are, it will be necessary to take greater responsibility for the future if we are going to ensure a better legacy for future generations. We cannot presume technical progress will solve all the problems. Rather, we have to take deliberate steps to reduce the federal deficit, to manage our energy and environmental endowments, and begin to take strategic steps to plan for the care of an aging population. Admittedly, a new surge in productivity growth would help to solve many of our problems. But we cannot count on that happening.

The next major report from the Council will focus on the service sector – the source of 97 per cent of the new jobs created in Canada in the 1980s. This report will highlight what is happening to workers in the service economy – and particularly on the quality of service jobs. And, it raises some important issues with respect to labour-market policies for the future.

Leaders will note in this issue that we have made a number of changes to *Au Courant* in an effort to improve our communications. Through the card attached to this volume, we are also asking you to indicate whether you wish to receive the magazine in the future. While the articles here are highly condensed reports on what we are doing at the Council, the magazine allows us to present, to a much wider audience, the essence of our ideas and our advice to government.

A leaner legacy

The main subject of this issue of *Au Courant* is the 26th Annual Review just released by the Economic Council of Canada.

Entitled *Legacies*, the Council's 1989 Review focuses on the heritage we are going to leave to tomorrow's generation. The prospects are not entirely reassuring.

In this year's Review, the Council studies in detail several problems that are particularly urgent: the deficit, declining productivity, the "greying" of the population, and our worsening environment.

The Review ends by proposing a framework and objectives designed to correct some of the unfavourable trends in order to preserve the equity between present and future generations.

Unless Canada's economic performance greatly improves in coming years, there is a risk that the economic, social, and environmental legacies we leave to the generations of the early 21st century will be leaner than today's.

If we fail to act without delay, a modest improvement over the standards of living we have enjoyed during the last decades will be the most our children can look forward to when they retire. And if we do not immediately address the problem of cleaning up the environment, their quality of life may also be poorer than our own.

It is still not too late, however. The time is ripe; the expected expansion in international trade and the wealth of opportunity that will flow from freer trade may signal the start of a new era of prosperity for a resource-rich country like Canada.

As Canada approaches the last decade of the 20th century, it is only natural that the Economic Council of Canada should reflect on the legacy, in terms of the potential for higher living standards and for a healthy environment, that we have received from our parents, and on the one we will leave to our children. It is to the question of this uncertain heritage – its causes, its consequences, and what can be done to improve it – that the Council devotes its 26th Annual Review.

According to the Council's analysis of the situation, equity between generations is far from assured. To achieve this goal, Canadians must waste no time in adopting measures aimed at improving the economic climate, while keeping a watchful eye on the consequences of their actions for future generations.

In its Annual Review, the Council singles out a number of major problems that urgently require our attention: Canada's declining productivity, the high federal deficit, and an excessive foreign debt that threatens to adversely affect both present and future generations.

The aging of the Canadian population will mean a new set of demands on the economy. While persons aged 65 and over account for 11 per cent of the population today, that proportion will have risen to 21 per cent three decades hence and to 30 per cent by 2040. Will working-age Canadians of the future be able to meet the financial obligations implied by this trend, given the impact it will have on the cost of pensions, health care, and the other needs of an older population? What might be the effects of changing birthrate and immigration patterns on the "greying" of our citizens?

Finally, what about the environmental situation, which, despite the imposition of new standards, remains extremely worrisome for the future?

A constantly changing context

As Canadians enter the 1990s, they are caught up in a tide of global economic change. National boundaries are no longer the obstacles to trade that they once were.

Whether Canadians want it or not, notes the Council, they must accept the fact that heightened global competition, reinforced by the wider availability of new scientific and high-technology achievements, is shortening both the lives of products and the processes of production.

Against all expectations, recent developments have not led to greater output and rising worker productivity. In fact, productivity growth is slowing throughout the member nations of the Organisation for Economic Co-operation and Development (OECD). Even in the United States, which still edges out other nations in overall productivity and per-capita income, the annual growth rate is running at less than 1 per cent. In Canada, it held at slightly over 2 per cent during the recent economic recovery (1983-87), but the Council projects an average of around 1 per cent for the next few years. While some Canadian industries have responded quickly to the far-reaching developments seen in recent years, others are adopting more of a wait-and-see attitude, and may be beaten out by more alert competitors.

Internationally, the competitiveness of Canada's resource industries remains strong. But of late, the measured productivity growth in manufacturing has slackened.

The Council lays particular emphasis on the need for the federal government to change its mix of fiscal and monetary policies. The persistence of the deficit, through good years and bad, provides a prime example of the reluctance of governments to seriously address awkward political problems before they assume crisis proportions.

Objectives

In light of these somewhat gloomy perspectives at the approach to the 1990s, the Council highlights the following objectives:

- The restoration of the federal government's fiscal balance in order to foster an economic environment that, together with appropriate government measures, will enable market forces to function more efficiently and will encourage a favourable business response to the new opportunities inherent in the Canada-U.S. Free-Trade Agreement and the Uruguay Round negotiations of the GATT.
- The need to anticipate long-term measures to assist the growing ranks of the elderly.
- The need to undertake new initiatives to preserve environmental quality.

The most pressing priority, stresses the Council, is raising the rate of productivity growth in both the public and private sectors in ways that will contribute to rising real incomes, regional balance, and full employment.

The economy and a balanced budget

The health of the Canadian economy depends, in large measure, on that of the United States. Thus any move aimed at improving the U.S. economic situation, particularly at reducing that country's deficit, is likely to have a positive impact on Canadian efforts in the same vein.

Some progress has been made on the U.S. economic front: exports have increased, the U.S. federal deficit has declined, and there have been efforts to formulate a debt-reduction strategy. Yet, points out the Economic Council of Canada in its 26th Annual Review, there is still much to be concerned about in the U.S. economic picture.

The U.S. current-account balance remains huge (US$120 billion). The decline in the federal deficit, meanwhile, is actually quite slight, and the deficit now stands at US$140 billion. The Third World's debt load is still compounding and there has not been much support so far from the commercial banks, which hold 60 per cent of this debt, for the proposed plan to forgive loans and cut interest rates.

What is perhaps one of the most remarkable developments of the 1980s is the transformation of the United States from being the world's major lender to its major debtor. The United States will likely remain a capital importer throughout the 1990s, drawing primarily on Japanese and European savings to cover its external debt. Given the United States' weight on international markets, upward pressure on nominal interest rates is likely to be felt in other deficit countries, such as Canada, that rely on foreign capital inflows. Clearly, says the Council, these factors will have a significant impact on the conduct of economic policy in Canada.

The Review surveys the situation in, among other regions, Latin America, where the flow of new private investment funds has virtually dried up. The result is a vicious circle: the lack of foreign investment impedes the importation of new equipment, thereby inhibiting domestic economic growth and the stimulation of exports needed to provide the earnings that will service the debt.

In Asia, on the other hand, the economies of the Pacific basin are booming. Over the past decade, several of these countries have generated productivity growth rates which are twice as high as OECD rates. With their young population, their strong emphasis on higher-value-added products for export, and rising incomes, the commercial importance of this part of the world can only expand in the years to come. In the high-technology exports sector, for example, Japan and the newly industrialized countries of the Pacific basin have succeeded in increasing their market share from 10 per cent in 1971 to 25 per cent in 1986. Canada, by comparison, is barely managing to hold on to its 3 per cent of the same market.

The Council is also concerned about the persistence and size of Canada's federal deficit, which complicates the conduct of economic policy. Particularly worrisome, says the Council, is the fact that it continues to persist after seven years of relatively strong economic growth. The size of the deficit in an economy that is operating at close to full manufacturing capacity puts the burden of containing domestic inflation squarely on monetary policy.

Even though Canada has benefited from the globalization of capital markets and the recovery of world trade, the Council finds that federal "fiscal imprudence" has introduced distortions into the Canadian economy that are harmful to the country's long-term commercial competitiveness.

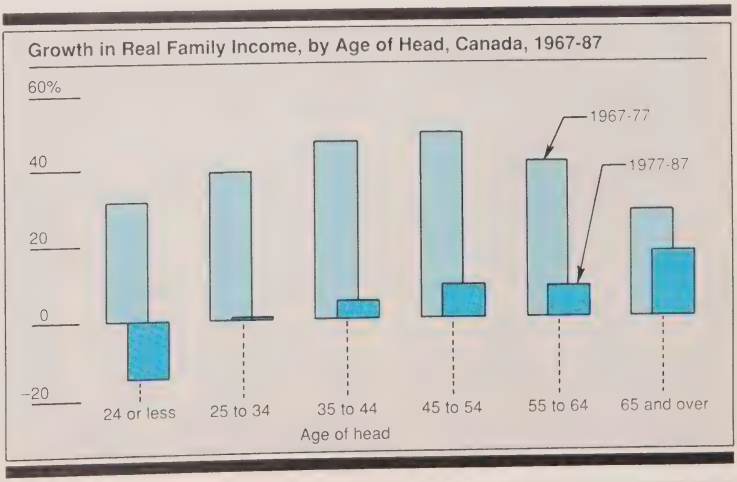
As in the United States, Canada's present mix of monetary and fiscal policies has effectively raised the price of capital relative to labour and encouraged more labour-intensive service activities. Current policies have also deterred at least some of the new investment needed to modernize various sectors of Canadian industry and have contributed to the build-up of foreign indebtedness.

Canadian industrial competitiveness

For a medium-sized open economy like Canada's, trade is vital to continued prosperity. Canada exports around 34 per cent of what it produces, and it imports a corresponding portion of what it consumes. Looking to the years ahead, the Council finds the potential challenges and opportunities daunting, to say the least.

The implementation of the Canada-U.S. Free-Trade Agreement, the integration of the European Economic Community after 1992, and the emerging markets of the Pacific Rim offer important trade and investment opportunities for Canadian businesses. These developments, however, will also test their mettle.

Canada has traditionally been and continues to be a major exporter of primary resources – wheat, energy,



lumber, pulp and paper, metals and chemical products. In 1988, these items accounted for more than half of Canada's merchandise exports.

Of all the major countries, Canada's overall levels of productivity and per-capita income are closest to those of the United States. This situation is less heartening in manufacturing, however, where the Americans are far ahead. And, during the 1980s, Canada's manufacturing productivity performance was surpassed by West Germany, France, and Italy. These points suggest that Canada is adapting more slowly than its trading partners to the new international environment.

However, the picture of Canada's economy is not uniformly grim. Historical evidence suggests that Canadian firms operate with a keen eye on the exchange rate. When the dollar gains strength, manufacturers face competitive pressure to revitalize their operations and improve productivity. A weaker dollar, on the other hand, tends to protect them from foreign competition and so to retard the pace of productivity improvement. This factor was particularly evident in the early 1980s.

Much of Canada's future productivity performance will be determined by the ability of Canadian firms to assimilate and use new science and technology. In fact, our expectations of future income will depend on our performance in this regard. Unfortunately, Canada's report card on this score is poor, no matter what measure is used – research and development, patent registrations, availability of scientists and engineers, or the trade performance of high-tech industries.

Despite these difficulties, indications are that many Canadian manufacturers are responding to the challenges of freer trade with the United States and growing international competition. The industrial heartland in Ontario and Quebec is operating at full capacity. The Review finds it noteworthy that, according to a recent survey conducted by the Canadian Manufacturers' Association, 80 per cent of CMA members judge they have had no problems or only minor problems in adjusting to the Free-Trade Agreement.

Resolving the fiscal imbalance

While the Canadian economy is entering a period of slower growth, the Council does not expect it to develop into a recession.

The continued resurgence of investment by industries preparing themselves for a more integrated North American market and for new export opportunities will support economic activity.

In the Council's view, the Achilles' heal of the Canadian economy in the coming period is the federal government's fiscal position. Deficit reduction has fallen far short of explicit targets, and the long, drawn-out process of deficit correction proposed for the 1990s will clearly be subject to many risks.

In any event, the principal legacy of the 1980s to future generations may well be a huge public debt. In 1988, the net financial debt of federal, provincial, and local governments and their agencies was about $400 billion, or over $15,000 per capita. Among the other OECD nations, only the United Kingdom and Italy have higher debt/GNP ratios.

Of even more concern that the size of the debt, however, is the fact that it continues to grow.

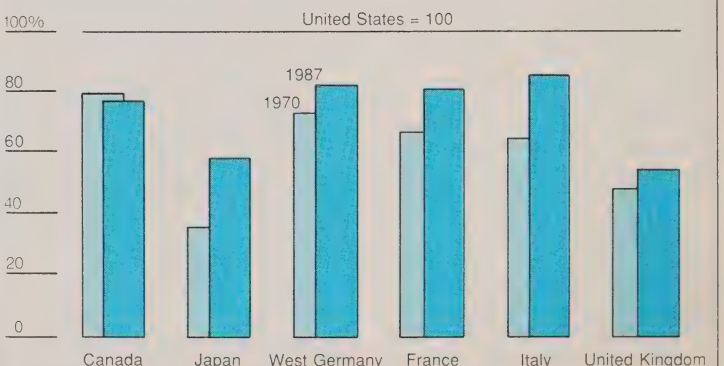
While the Council presents a number of scenarios in its Review, it will remain the responsibility of the federal government to choose the appropriate timing and assess the proper dose of restraint when considering new policy options intended to speed up the return to a more robust fiscal position. The key considerations will be the strength of demand, the scope for a concomitant relaxation in monetary policy, and policy developments in the United States.

The Council comes out in favour of spending cuts, but recognizes that the timing and extent of such cuts, along with the associated easing of monetary policy, must be tuned so as to avoid excessive increases in unemployment.

Any made-in-Canada solution to the fiscal dilemma relies primarily on a gradual easing of monetary policy. Thus, states the Council, the next round of expenditure cuts should be made at a time when the Bank of Canada is in a position to reduce interest rates, such as when prices are experiencing minimal upward pressure.

The best prospects for a favourable environment for Canadian restraint, feels the Council, will come with improvements to the United States fiscal position.

Level of Labour Productivity in Manufacturing (Output per Hour) in Selected Countries Relative to That of the United States, 1970 and 1987



The current generation

Successes and concerns

Overall, the 1980s have been years that warrant both satisfaction and concern for the present generation.

During this period, as the Economic Council of Canada notes in its 26th Annual Review, Canada achieved a significant restructuring of industrial activity and a record of employment growth that outpaced that of most other OECD countries. On the other hand, historically high unemployment rates have persisted in many outlying regions, and wages on the whole have not risen during the past decade.

If families had had to depend solely on the earnings of one breadwinner, there would have been almost no growth in real family incomes between 1973 and 1986. Because of the phenomenal influx into the labour market of women and working-age youth, there was actually a 13-per-cent increase in real incomes over this period. Yet, the contribution of the household head to family income dropped by 5 per cent.

Among single individuals under age 64, there was a 20-per-cent increase in real income over the period. Much of this apparent gain stemmed from the rising divorce rate, which resulted in the growth in the number of single skilled and professional people aged 35 to 54.

The Canadian economy produced over 600,000 new jobs between 1981 and 1986, giving this country one of the most favourable job-creation records among industrialized nations. Most of the growth in the labour force can be attributed to women, who filled 72 per cent of the new jobs created over the decade. In 1988, 57 per cent of all women of working age were in the labour force, compared to 50 per cent in 1980. In terms of female participation rates, Canada ranks high among the OECD countries.

Employment growth in Canada during the 1980s has been concentrated in a few occupational groups: managerial, administrative and related occupations, medical and health occupations, and the sales and service industries.

A much different picture is revealed, however, when wages are examined. In real terms, there has been little improvement and, in fact, labour income per worker in 1987 was almost 2 per cent lower than it had been 10 years earlier.

The Council observes that, collectively, Canadians are only modestly better off than they were a decade ago. While some groups are doing quite well, others are falling behind in terms of employment and income. Many blue-collar occupations are disappearing; unemployment rates outside central Canada are still high; and there are signs of wage polarization between well-paid skill demanding jobs and those that are low paid, dead-end, and relatively unskilled.

Somewhat ironically, the Review points out that seniors have benefited the most from these developments.

The proportion of elderly below the poverty line fell dramatically between 1971 and 1986 – from 68 to 16 per cent of individuals, and from 35 to 6 per cent for families.

While Canada's unemployment rates have dropped significantly during the past six years, they have still not attained pre-recession levels (1982) and they remain higher than the OECD average. In many parts of the country, the Council believes, unemployment rates remain wedged at unacceptable levels. The proportion of unemployed who were out of work for more than 14 weeks has risen during the 1980s from 37 to 42 per cent.

The 1980s have also seen a significant shift in employment to the services sector. The gap in hourly wages between workers under 35 years of age and their older colleagues has widened. The majority of Canadian workers are not covered by private pension plans.

Overall, the Review reveals that Canadians with good jobs at the high-income end of the scale, their savings and pensions fueled by high interest rates, can look forward to relatively affluent retirements. For those in low-paying jobs with limited career prospects, however, the future may be bleaker.

In light of these discouraging findings, the Council poses the following questions about Canadians who are facing economic hardship:

- Will the insecurity plaguing their income and employment situations haunt them the rest of their working lives?
- What are their chances for career advancement?
- Are there adequate facilities for training programs, particularly in regions where permanent employment is scarce?
- How mobile must these workers be?
- How adequate will their public pension plans prove to be when they retire?

The Council's conclusion is that it is still too early to say there is a well-defined group – a "lost" generation – experiencing persistent economic insecurity. Still, in parts of Canada, there is cause for concern. The Council hopes to shed more light on this situation shortly through its future research on unemployment and social policy.

Average Annual Growth in Real Labour Income and Productivity, Canada, 1966-87



Two questions for the future

Aging and the environment

The aging of our population will increase the responsibilities that must be borne by future workers. Similarly, our abuse of the natural environment today and the economic resources we are prepared to devote to improving it tomorrow, to a large extent, will determine the legacy we will pass on to future generations.

The Economic Council of Canada gives a prominent place in its 26th Annual Review to the discussion of these two questions, believing that they will have a crucial long-term impact on our country's future.

Canada's social and economic agenda very much depends on demographic trends.

There is no doubt that Canadians, as a group, are growing older. The proportion of those aged 65 and older has more than doubled since 1921, rising from 5 to 11 per cent of the population as a whole. Young people aged 19 years and under are proportionately fewer today than they were 60 or 70 years ago.

To analyse this phenomenon, the Council constructed a series of demographic scenarios. The base-case scenario assumed constant fertility rates and continuing low immigration of about 60,000. In the low-growth scenario, fertility rates declined further; in the high-growth scenario, fertility rates rose to replacement levels and immigration doubled to 120,000 persons per year.

By the year 2000, the spread between the high and low cases would be about 2 million persons. By 2040, the population in the high-growth case could be 15 million more than the low-growth case. Obviously, figures such as these have enormous implications for human-resource planning.

Whatever projection is chosen, there will be between 10 and 11 million Canadians aged 65 and older in the year 2040, up from just under 3 million in 1988.

In the low-growth case, the number of people under age 20 falls from 7.4 million in 1988 to 6.7 million in 2000 and to 3.9 million in 2040. In the high-growth case, the young population rises to 11.6 million in 2040. That development, says the Council, will clearly be the major swing factor in Canada's economic future.

It is the 20-to-64-year olds who will be most crucial to the cohesion of Canadian society, since they will be the producers of the goods and services used by all age groups, and they will be the care givers to both elderly and children. Because of the rising ratio of retirees to workers, improvements in the living standards of working Canadians and their children may well prove more difficult to achieve.

The Council's purpose in exploring these scenarios is to determine the risk of a clash in priorities between future workers and retirees; also, it is to identify the policy levers available to head off this crisis. Productivity growth, which has been lagging in recent years, could hold the key: continuation of the projected rates of less than 1 per cent could mean trouble, whereas an increase of 2 per cent a year would allow more generous solutions.

The environmental legacy

In considering the implications of current social developments for future generations, the Council maintains, one must look beyond mere statistics. We must explicitly take into account the environmental and resource legacies. On this score, the outlook is not encouraging.

Still, appropriate long-term management should make it possible to preserve and even enhance the value of our renewable-resource base.

The introduction of more stringent federal controls, including the promulgation in 1977 of a 200-mile limit for Canada's fisheries jurisdiction, has had some positive results. Nevertheless, the management of the fishery continues to pose a major challenge, particularly in light of the recent finding, for example, that northern cod stocks are far below previous estimates.

Problems of resource management are also evident in the case of other renewable resources, such as forests and farmland. For example, as a result of years of inadequate long-term management, the organic content of soils has declined by between 36 and 49 per cent in the Prairies and by 50 per cent in Ontario and Quebec. A report by a Senate standing committee estimated that soil degradation costs Canada $1 billion a year in lost income. Canada loses almost twice as much productive forest land through fires and pests as it does through planned harvesting. Planting, seeding, and natural regeneration compensate for only about 70 per cent of the annual loss.

The Council notes that difficulties are mounting in meeting the growing requirements of waste management. In 1985, some 25 per cent of the population in large communities (over 100,000 people) was not served by waste-water treatment facilities. And it is becoming increasingly difficult to find suitable places to store or dispose of various forms of municipal and industrial wastes.

Ambient air quality has improved between 1975 and 1985 in Canadian cities. But the Council finds there are still areas of concern. Average ground-level ozone concentrations in urban areas have remained well above "maximum acceptable" levels. On a per-capita basis, Canada's carbon-dioxide emissions are among the highest in the world. Acid rain also represents a serious problem; the Council points to the costly damage it has caused to fisheries, forests, agriculture, and wildlife.

Estimates of the investment that would be required over the next decade to reach some reasonable baseline standards of air and water quality have produced a bill of $50 billion.

The Council acknowledges, therefore, that the necessity for environmental clean-up will make major demands on the economy over the next decade.

The challenges of environmental responsibility are many and complex. To what extent should we tighten our belts now to finance the investments needed to help our descendants weather the crucial years when the current baby boomers have retired?

The potential impact of the slower productivity growth observed in recent years, combined with building demographic pressures and disturbing environmental trends, provides a compelling argument for reorienting government policy so that much greater importance is given to the consequences of current activities for future generations.

An inheritance to bestow

An efficient, competitive economy, capable of meeting the economic and quality-of-life needs of its citizens, unencumbered by a huge overhang of public and foreign debt – this is how the Annual Review of the Economic Council of Canada sums up the best possible legacy that the current generation could bestow upon tomorrow's Canadians.

The challenges are many, and they will require investments that must take into account a multitude of factors, including the productivity growth rate, the competitiveness of Canadian industry, employment and unemployment, incomes, demographic change, and environmental concerns. Still, there is one priority that stands out above the others, one that requires urgent action because of its impact on all facets of the problem. It is deficit reduction.

If the future is conditioned by the present, then our legacy to tomorrow's generation will be a heavy federal deficit and an excessive foreign debt.

The deficit

Thus one of the main targets suggested by the Council to the federal government is a steady reduction of the federal deficit from today's level of well over 3 per cent to 1.5 per cent of GDP or less by 1993.

Although the federal government has managed to narrow the gulf between expenditures and revenues since 1984, the mix of economic policies in the 1980s has turned out to be damaging to the nation's long-run potential. While it has contributed to employment growth, it has also dampened productivity.

While many industries are operating at near capacity, there is now growing evidence, says the Council in its Review, that the economy is entering a period of slower growth. Accordingly, our targets for real growth, the unemployment rate, and the inflation rate must be consistent with each other and must be sensitive to the dangers of overheating the economy.

The Council foresees an international financial and economic context in which real interest rates are likely to exceed real rates of growth in Canada. This situation makes reduction of the deficit an uphill battle, and can lead to an explosive growth in public debt. In this kind of environment, federal fiscal policy must do all that it can to forestall a debt crisis. In the wake of the April 1989 federal budget, taxes – including the goods and services tax, designed to improve economic efficiency – have pretty much reached the limit that Canadians can digest. This means that every available opportunity must be used to reduce expenditures in order to speed up the process of deficit reduction.

Second, we must be concerned about the effects of poor productivity performance. Already, there has been a slowing-down of real income growth and an apparent reduction in the real incomes of young Canadians. A failure by business to adopt new technologies, or to move towards higher-value-added production, might well doom many workers to low-income, high-turnover jobs with little chance of advancement.

If productivity gains do not improve, per-capita income growth could drop to less than 1 per cent annually by the year 2020, when at least part of the baby-boom generation will have retired. Economic expansion could be so slow that meeting the new social demands of one group could well require shrinking the entitlements of others, resulting in an escalation of social tension. Canada would then be close to a "zero-sum" economy.

Economic targets

In order to meet these various challenges, the Council proposes the following economic targets:

- an increase in productivity, as measured by output per employed person, of between 1.5 and 2 per cent annually;
- employment growth of 1.5 to 2 per cent annually, so as to reduce the unemployment rate to between 5 and 7 per cent of the labour force by 1993;
- a rate of GDP growth of 3 to 4 per cent;
- a rate of annual inflation of 4 per cent or less;
- the preservation of the objectives and substance of existing social programs, insofar as they provide affordable benefits to Canadians; and
- the achievement of regional balance with respect to growth and employment possibilities.

The impact of the demographic crunch associated with the retirement of the baby-boom generation will not be felt for some 25 years. In that interval, the Council believes, there is a window of opportunity to eliminate the deficit, make substantial progress in shrinking our foreign debt, and step up efforts to clean up the environment.

For the growing ranks of the elderly, there is a host of issues that will warrant public debate, including the age of retirement, adequacy of pension coverage, and health care. Solutions might include encouraging seniors to adopt a more active and healthful lifestyle, to work longer after age 65, to undertake new careers or start new businesses, or to participate in voluntary activities.

If current patterns of hospital use continue, the aging of the population could result in a dramatic increase in health-care costs over the next 50 years.

The Council recognizes that it will be the responsibility of the Cabinet to determine which programs should be rationalized, where additional expenditures could be made, and when they should be introduced. To guide these decisions, the Council recommends the four following principles:

- Keep deficit reduction as a primary objective, but try to balance the choices along the way.
- Recognize that falling interest rates would provide a substantial offset to the negative effects of deficit reduction.
- Capitalize upon any positive decisions by the United States in the area of monetary and fiscal policy.
- Concentrate on expenditure cuts in implementing fiscal-restraint measures.

The most recent initiatives of the government, notably the last federal budget with its emphasis on reducing the deficit and encouraging long-term growth, would likely lead to a balanced budget by the turn of the century. The Council believes, however, that this course is too gradual and fragile. It concludes, therefore, that further expenditure reductions, combined with action on the monetary side, will be required.

High-tech trade

Serious weaknesses to solve

Canada's competitive position in high-technology trade is weak on several scores. And this gloomy picture threatens to become even bleaker unless immediate action is taken to correct the problem.

According to two senior economists from the Economic Council of Canada, Sunder Magun and Someshwar Rao, the gravity of this situation demands that Canada urgently undertake a major review of its science and technology policies. The researchers stress that the problem must be addressed soon if it is not to severely affect Canada's productivity, international competitiveness, and standard of living.

Speaking recently to a meeting of the Canadian Economics Association in Quebec City, the two researchers explained that their study, which used Statistics Canada's new World Trade Data Base, reveals clear weaknesses in Canada's competitive position. Striking proof, they say, is offered by Canada's significant losses on world markets and its persistent trade deficits with respect to high-technology products. Magun and Rao find particularly disturbing the dramatic decline in Canada's share of the U.S. market, as well as the country's very low penetration in the Pacific-Rim market that serves the newly industrialized countries (NICs).

The structure of Canada's high-technology trade

Canada is a relatively small exporter of high-technology products. Its exports are concentrated mostly in a limited number of commodity groups, including aircraft and associated equipment, telecommunications equipment, and automatic data processing machines.

In 1986, Canada exported $8.7 billion of high-technology products of these kinds, and imported $11.4 billion. Its main clients are the European Economic Community and the United States. The United States is Canada's biggest customer, accounting for three quarters of Canadian exports and more than two thirds of Canadian imports.

Although Canada has developed strong ties with the Asian NICs in recent years, its exports to this part of the world remain very low.

Canada's share of exports of high-technology products in its total manufactured exports is lower than for any other industrialized country. In 1986, high-tech exports accounted for 14 per cent of total Canadian manufacturing exports. The same figure was 11 per cent in 1971, indicating relatively little change in Canada's export capability over a 15-year period when both markets and competitors have changed rapidly.

In the United States, exports of high-technology products account for 38 per cent of all manufacturing exports. Over the 1971-86 period, the Japanese doubled their proportion to 28 per cent. The figure for Asian NICs, meanwhile, almost tripled, climbing from 9 per cent in 1971 to 24 per cent in 1986.

World market shares

According to Magun and Rao, Canada's weak performance in the high-tech sector can be seen even more clearly when trends in Canadian shares in world exports of high-technology products are analysed.

Canada has a 2.6-per-cent share of the world high-tech market (down from 3.5 per cent in 1971). This is a meagre share of a market worth some $330 billion a year.

The stunning rise of Japan and the Asian NICs, say the two economists, is the most dramatic development in the global high-tech market.

Japan's share of the world market rose from 8 per cent in 1971 to over 17 per cent in 1986. The shares of the Asian NICs jumped from 1.5 to over 9 per cent during the same period.

The two researchers also point out that Canada's decline in this market is not confined to a few product areas but has affected the entire range of high-technology goods, including those in its areas of specialization (mentioned earlier).

Canada-U.S. trade

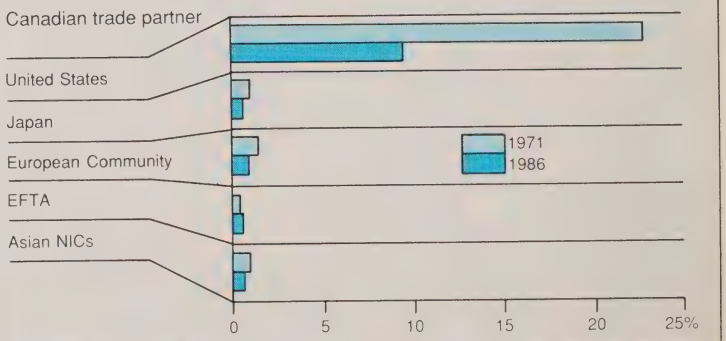
The dramatic drop in Canadian high-tech exports to the United States is disturbing, say Magun and Rao, because Canada relies so heavily on the U.S. market in this area.

In 1971, over 20 per cent of U.S. high-tech imports came from Canada. This figure slumped to less than 10 per cent by 1986. Worse, stress Magun and Rao, this significant loss occurred during a period when U.S. imports were on the rise worldwide, increasing eighteenfold between 1971 and 1986.

In contrast, Japan benefited greatly from the burgeoning U.S. market. Statistics show that its share of this market expanded from 28 to 35 per cent over the same period.

Magun and Rao also point out the

Canadian Shares in Trade Partners' Imports of High-Technology Products, 1971 and 1986



phenomenal increases that have occurred in the NICs' share of the American market. From 7 per cent in 1971, this figure jumped to over 20 per cent in 1986.

Trade deficits

Noting that export shares alone can sometimes lead to misleading conclusions because of the expansion of intra-industry trade, the two economists feel it is important to assess the problem using other yardsticks. One of these is a country's trade balance over time.

Here again, Canada's overall weakness in high-tech exports reveals itself in the form of persistent deficits.

The United States and Japan, by way of contrast, posted large high-tech trade surpluses until 1981.

While Japan has managed to sustain this upward trend, the researchers note, the United States has more recently incurred sizeable deficits.

Research and development found wanting

Magun and Rao believe that one of the main factors in the lamentable state of the Canadian high-tech industry is our low research and development (R&D) activities.

The two researchers cite figures showing that, among all industrialized nations, Canada spends the least on R&D.

In 1985, Canada devoted only 1.3 per cent of its gross domestic product (GDP) to R&D, compared to Japan's 2.8 per cent and the United States' 2.7 per cent. The share of spending on research has not increased significantly in Canada for close to 25 years. Canadian industry's share of total R&D expenditures is also the lowest among all the G-7 countries. The Canadian business sector, for example, accounted for only 48 per cent of total R&D expenditures, compared to 72 per cent in the United States, 71 per cent in Germany, and 65 per cent in Japan.

Canada's low level of R&D activity is reflected in patent applications. In 1983, Canadian applications accounted for only 0.5 per cent of the total patent applications of the G-7 countries. This contrasts sharply, note the researchers, with Japan's 68 per cent and the United States' 14.5 per cent.

Conclusion

According to Magun and Rao, their results clearly show the weaknesses of Canadian industry on international high-technology markets.

Not only has Canadian industry failed to adapt to rapidly changing demand patterns in this highly specialized sector, but it has also proven unable to improve its productivity and manufacturing costs. That is why the Canadian high-tech industry has missed so many opportunities to expand its exports abroad, particularly to the United States.

The two researchers thus see an urgent need for an exhaustive study of Canada's position in high-technology trade – before it is too late.

New members appointed to the Economic Council



Peter M. Brophy is vice-president, Corporate Affairs of Xerox Canada Inc. in Toronto. A graduate of McGill University, he is vice-chairman of radio station CJRT-FM in Toronto and an advisor to the Ontario minister of Industry and Trade. He is a director of the Information Technology Association of Canada.



Michael A. Sullivan is a self-employed chartered accountant in Summerside, P.E.I. A graduate of St-Dunstan's University, he is also chairman of the National Products Marketing Act Appeals Tribunal. He is secretary-treasurer at J. Erskine Clark and president of Two Plus Two Jewelry Ltd.



Rix Rogers is president of Rix G. Rogers and Associates of Oakville, Ontario. A graduate of the University of Toronto, he is also a special advisor to the minister of National Health and Welfare. He has been general secretary and Chief Executive Officer of the YMCAs of Canada and chairman of the National Voluntary Organization.



Struan Robertson is chairman of the Central Guaranty Trust Company in Halifax. A graduate of Dalhousie University, he is a director of the Canadian Chamber of Commerce. He has held various positions such as president of Central & Eastern Mortgage Corporation and Chairman of the Board of Central Trust.

"Decoupling" and Prairie farmers

A more even-handed program

The financial crisis that has gripped Canadian Prairie farmers is the result of low and unreliable farm incomes, unstable prices on world grain markets, and unfavourable weather.

In a recent study, Ludwig Auer, a senior economist at the Economic Council of Canada, traces the origin and severity of the difficulties faced by Prairie farmers and concludes that present support programs should be replaced by assistance tied, not to the production of specific crops or to production volumes, but rather to farmers' incomes. Such "decoupling," believes Auer, would provide income assistance for farmers while breaking the link between the extent of financial aid and the production of specific crops, the prices of particular commodities, cultivated area, and production quantity.

According to the author, current government subsidy programs do help to stabilize and increase farm incomes, but only in the short term. In the long run, they drive up production and drive down prices, with the result that the real beneficiaries of most programs designed to support Prairie farms are not the farmers, but rather the consumers, in both Canada and abroad.

Current programs do not resolve farmers' income problems, despite their high cost to the public purse. In 1987, for example, direct government payments to farmers in the three Prairie provinces amounted to some $1.7 billion. And that figure does not include an $815 million emergency payment under the Special Canadian Grain Program, nor indirect assistance in the form of farm credit, freight subsidies, crop and livestock research, food-aid and food-trade programs, and social adjustment and rural development.

If all these direct and indirect components were included, total assistance to Prairie farmers in 1987 would jump to $4 billion – an average of about $30,000 per farm. Yet in the long term, the net incomes of farm workers are 40 per cent below those of Canadian workers in other categories.

The extent of aid given out by the Public Treasury in the form of agricultural assistance is increasingly the target of political pressure. Calls are being heard for across-the-board reductions in subsidies and for freer agricultural trade. That is why Canada and other countries have made a commitment, under the General Agreement on Tariffs and Trade (GATT), to eliminate agricultural subsidies affecting international trade by the year 2000.

Still, notes Auer, the prospects for Prairie agriculture between now and the next century are not very encouraging. If current trends continue, the cost/price squeeze may lead to a gradual decline in the number of farms in the Prairie provinces. Between now and the year 2000, their number may fall from 130,000 in 1985 to 115,000 or possibly as low as 95,000.

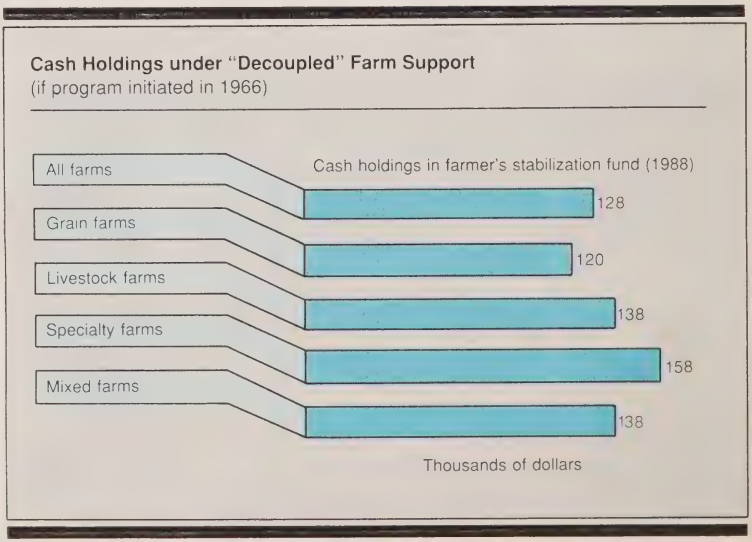
The substitution of decoupled-assistance programs for the present support programs, the author cautions, will require careful planning and intensive negotiations with farmers and the provincial governments. A favourable economic climate both domestically and abroad will also be essential.

Costs

The author's simulations, carried out with 3,500 Prairie farmers, show that while implementing decoupled support would not necessarily have been less expensive in the very short term, it would have allowed assistance to be distributed much more evenly, avoiding, for example, a bias in favour of grain farmers and against livestock and specialty-crop producers.

According to the author, decoupled plans make the most sense economically when viewed in the longer term. He illustrates this claim with the following example. Government financial assistance in 1988 was $3.1 billion, bringing the cumulative total for 1966-88 to $13.5 billion. If a decoupled-assistance plan had been brought in during the 1960s, the government's contribution to farm assistance programs would have been $0.9 billion in 1988, for a cumulative total of $12.6 billion.

For their part, farmers contributed $0.2 billion to the various assistance plans in 1988, for a cumulative total of $1.9 billion over the period in question. Under a decoupled program over the same period, they would have contributed $0.1 billion in 1988, but (and here is the pay-off pointed to by Auer) the cumulative total would have been $12.9 billion over the 1966-90 period.



Decoupled-support programs

The author proposes a system comprising four decoupled-support programs, as follows:

- Farm-income insurance: designed to protect farmers against major losses of farm income, whether caused by unfavourable market prices or by adverse weather conditions; government and farmers would share the cost of the program on an equal basis.
- Income-stabilization fund: designed to encourage farmers to invest, tax free, a major part of their income gains from farming operations in a self-administered fund in order to protect against future income losses and thereby save on farm-income insurance; government would match the farmer's contribution, again on a one-to-one basis.
- Farm-adjustment option: would enable a farmer to treat the assets accumulated over the years in the income-stabilization fund as a tax-free capital gain when he leaves farming or retires.
- Family-income disaster assistance: would be triggered when provincial or regional farm incomes drop to disastrous levels and would help farmers to cover up to one half of their essential living expenses.

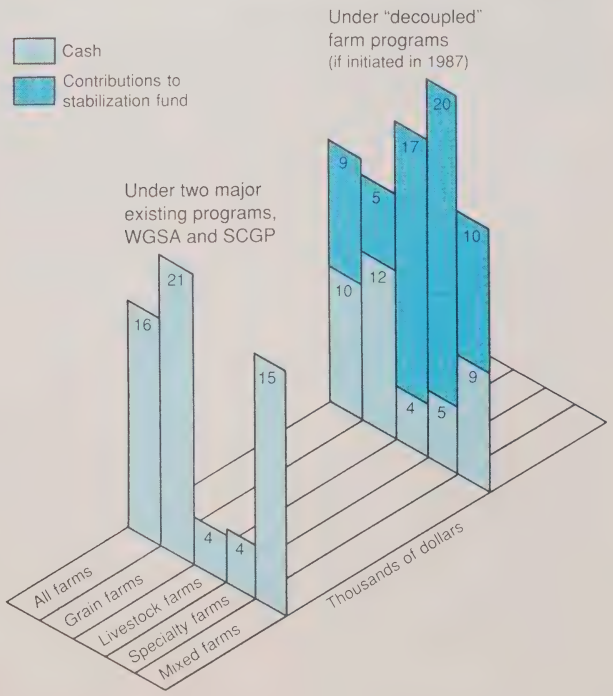
These four programs, Auer points out, would not be independent of each other but would be, to some extent, interactive and complementary. Among other benefits, they would enable farmers to weather market-price instability and short-term fluctuation in farm production and would also grant them greater freedom of action in the management of their operations.

As mentioned earlier, the federal and provincial governments paid out, on the average, $30,000 for each Prairie farmer in 1987. About half of these payments ($15,700) were cash payments awarded under two specific programs. The author also points out that grain farmers received subsidies some four to five times larger than those awarded to livestock producers. Hypothesizing that a decoupled-support program had been in place in 1987, farmers would have received slightly more – $18,000 instead of $15,700. Cash payments, however, would have been lower ($9,500), the remainder of assistance ($8,500) being composed of contributions to the farm-income stabilization fund to equal the amount that farmers themselves had invested in the fund.

If a decoupled-support program had been in place after 1960, the government's contribution for each farmer would have risen to $6,000 by 1988. The annual average over the 1960-88 period would have been $3,700.

The reason government contributions would have been lower is that farmers would have been able to draw upon their stabilization fund in order to support their farm operations. The cost of a decoupled program, Auer states, would depend directly on farmers' willingness to invest their savings in the stabilization fund. He argues that if, over the last 20 years, farmers had contributed approximately two thirds of their income gains to the stabilization fund in order to maximize the government's contribution, they would have accumulated average savings of about $100,000 in the fund.

Government Payments to Prairie Farms in 1987



A new look at a social curse

Poverty is the daily lot of hundreds of thousands of Canadian families. While the nature of this problem is intuitively understood, an examination of the problem from a policy-relevant perspective is extremely complex. Not only must one understand poverty in terms of the various dimensions of its impact on the lives of Canadians, but a policy-relevant investigation requires probing into the very nature of its causes.

Such is the challenge taken up by the Economic Council of Canada in launching a major research project aimed at throwing new light upon the extent and causes of poverty in Canada.

More than 20 years ago, the Council pointed out in its Fifth Annual Review that poverty was a fact of life not just for thousands of Canadians, but for millions. Although progress has been made on some fronts over the last two decades, the make-up of Canada's social policy has recently resurfaced as a major public issue.

There is no question that Canada must strive to maintain and to improve its position on the fiercely competitive and global economic playing field. Yet Canadians have made it clear that, despite the difficulties that lie ahead, they do not want the link between social policy and economic policy broken. In other words, they do not want to exclude one from discussions about the other.

It is against this backdrop that the Council will try to decipher the true nature of poverty in Canada by developing a better understanding of certain key aspects, such as its causes, the number of individuals and families it affects, the "temporary" and "permanent" aspects of poverty, its characteristics, and its severity and duration. The Council hopes to arrive at recommendations that will offer governments a series of options for change geared to the Canadian taxpayer's ability to pay for such changes.

To find out more about this ambitious research project, *Au Courant* interviewed its director, Brian Powell, a senior economist with the Economic Council of Canada.

Au Courant: *What are the specific objectives of your research project?*

Powell: There are three basic objectives. First, to better understand the nature and causes of poverty and social disadvantage in Canada. Second, to consider how the whole array of federal and provincial programs, from the income tax system to social assistance, interact with each other and how these interactions impact upon people with low income. Third, to cost out various options for change.

In undertaking this research, we shall of course have to take into account the many difficult issues confronting social policy reform, including the old chestnut of efficiency versus equity, behavioural response to programs including the thorny issue of work disincentives, as well as matters of jurisdictional issues, institutional and administrative implications, and last, but not least, costs in terms of claims on government treasuries.

Au Courant: *Do you feel your research will provide new answers, ones that are different from previous research in this area?*

Powell: Yes. In order to provide new insights into the nature of poverty in Canada, we decided to build an ambitious new database that would allow us to track typical families and individuals through time. In this regard, we were inspired by the pathbreaking work of the University of Michigan in the United States. By following several thousand families through five, 10, and then 15 years, Michigan researchers called into question a number of commonly held beliefs about income distribution, poverty, and welfare dependence. Previously, researchers using cross-sectional databases – that is, snapshots at a point in time – found that low-income individuals and families always had the same characteristics. Many researchers then made the mistake of assuming that these low-income families were always made up of the same people – that is, a permanent class of poor in society.

The U.S. study, however, demonstrated the highly volatile nature of the incomes of individuals over time, taking them both into and out of poverty or welfare dependence. It also revealed that, over a 10-year period, almost 25 per cent of the U.S. population needed to make use of the American safety net of social programs at one time or another.



Brian Powell
Research director

Our research will be aimed at examining the same kinds of questions for Canada. We will be looking at simple head counts of families and individuals below various poverty lines, as well as the depth of the poverty in which various subgroups of the population are situated. We will also examine a third dimension, namely, the duration of poverty and the causes of change in family circumstances.

Au Courant: *What will be your main research tools?*

Powell: We could not hope to emulate the American study where thousands of families were followed and interviewed periodically over many years. Such a study is costly and by definition requires almost a decade before results would be ready.

Instead, in conjunction with Statistics Canada, the federal government, the governments of Quebec and Nova Scotia, and the municipal authorities of

Halifax, we are creating a longitudinal *family*-income database using income tax data and administrative social assistance files covering, initially, the period 1982 to 1986. This database, which requires the merging of individual tax returns to create family income and then merging these data with social assistance records, is unique in Canada and for the first time makes it possible to study the dynamics of poverty and the dependence on government transfers. All of this is being done under carefully controlled conditions so that the researchers will never know the identity of the people being studied.

Au Courant: *What is involved in studying income dynamics and welfare dependants?*

Powell: By drawing a 10-per-cent sample from the our new longitudinal database, we can follow the fluctuations in income over time at both the individual and family level. We will be able to demonstrate the extent to which there is volatility in income flows with specific types of families and individuals moving up and down the income distribution scale. More importantly, we hope to shed light on the causes of such movement examining the extent to which both "social" and "economic" events are responsible for change. That is, the impact on family-income status caused by, say, marriage breakdown or teenage pregnancies. We will also explore the interactions between changes in family composition and changing employment conditions.

Au Courant: *How will you approach the whole question of social programs?*

Powell: Our research in this area is also highly innovative and, through the use of computer models, will show how all major federal and provincial social programs interact and their potential impact on families. For instance, we will be demonstrating how families of various types are "treated" by the system as a whole in terms of benefits received and taxes paid at various income levels. We can then assess how various components of government programs, such as tax back rates on benefits or child-care subsidies could provide positive or negative impacts on decisions to work or undertake training. We will be looking especially hard at how the system as a whole impacts upon issues popularized by the media and pressure groups in recent years such as the feminization of poverty, the working poor, and, of course, the children of those in poverty.

"Many researchers then made the mistake of assuming that these low-income families were always made up of the same people – that is, a permanent class of poor in society."

"It also revealed that, over a 10-year period, almost 25 per cent of the U.S. population needed to make use of the American safety net of social programs at one time or another."

Au Courant: *What kind of implications will your research have for policy development?*

Powell: We expect the research to provide suggestions for improvements in a wide range of the social programs. On a general level, the research should move us in the direction of treating the causes of poverty rather than the symptoms. More specific implications could be in terms of adequacy of benefits, the relationship of employment and training programs to income support, the equity and efficiency of the retirement income system, and the role of various programs in society that relate to children.

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PUBLICATIONS

Annual Review

Legacies (EC21-1/1989E; $8.95 in Canada; US$ 10.75 outside Canada).

This year's Annual Review considers alternative courses of action which will leave more favourable economic legacies to future generations of Canadians. It looks into the next century, when more than double the present proportion of Canadians will be 65 years of age and over, and it examines how the working generation of that time will cope with the additional health-care and income-support costs. Finally it urges additional fiscal restraint and the early restoration of the federal government's fiscal balance.

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than the Council.

Canadian Prairie Farming, 1960-2000 – An Economic Analysis, by Ludwig Auer (EC22-161/1989E; $10.95 in Canada, US$13.15 elsewhere).

This study assesses the magnitude of the farm-financial crisis in the Prairie provinces, identifies the underlying causes, examines the effectiveness of existing government programs, explores alternative policy options, and projects what farm adjustments are likely to occur in the future.

The study begins with a review of the developments of the 1960s and 1970s and then addresses the events of the 1980s. It examines what impact the financial crisis had on the commercial farms, part-time and corporate farms, on farms located in different soil zones, on crop and livestock farms, in each of the three Prairie provinces. After describing some of the problems associated with the existing farm programs, it focuses on a new approach that would not link farm programs to individual farm commodities. It shows how such a system of "decoupled" farm programs could be designed to replace some or all of the existing farm programs. The workings of the system are illustrated by estimating its potential benefits and costs, to farmers and government, as they would accrue over a period of three decades.

Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields or research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the sole responsibility of the author, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 363 "A computational analysis of alternative scenarios for multilateral trade liberalization," by *Alan V. Deardorff* and *Robert M. Stern.*

No. 364 "A general equilibrium analysis of the Canadian-United States bilateral trade agreement," by *R. Andrew Muller* and *James R. Williams.*

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

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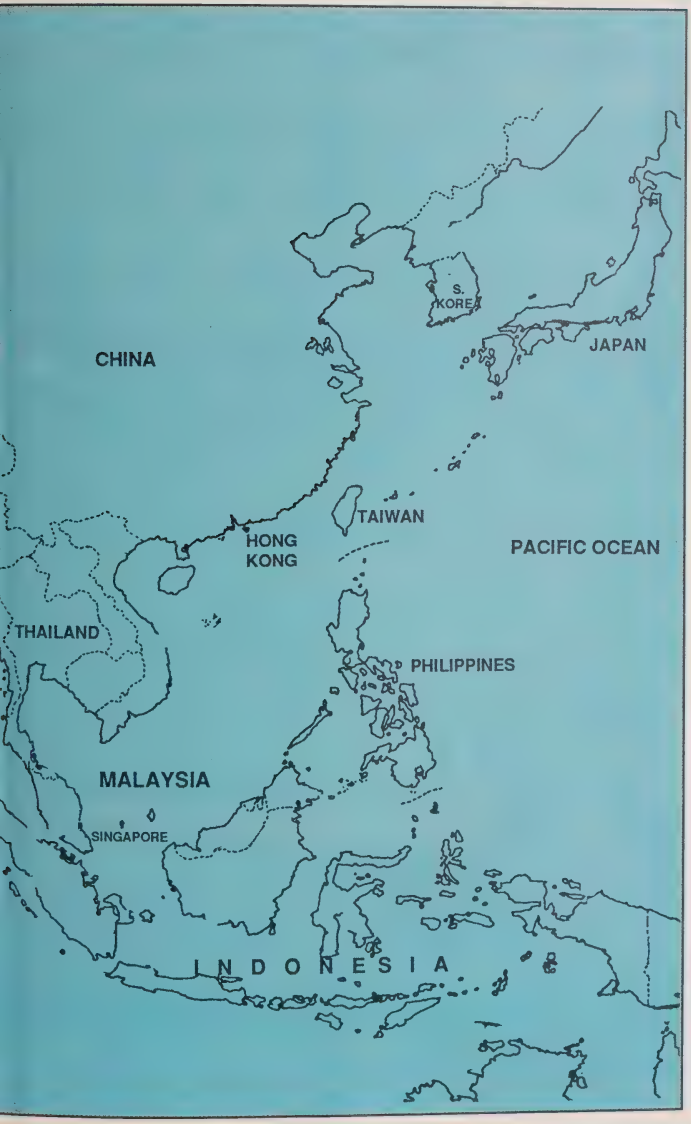
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Economic Council of Canada

Volume 10, No. 3, 1990

The Pacific Rim: A challenge



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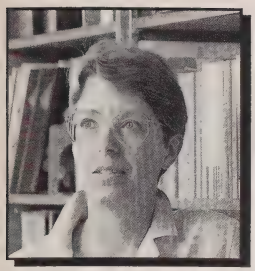
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Judith Maxwell

The New Challenges of the Nineties

Here come the 1990s. The last 10 years of a millennium that spans the decline of Charlemagne's Empire and the end of Stalinism in Europe. The novelist John le Carré has observed that in 1989, the "improbable is happening every day; and the impossible every week." We all pray that the new political structures will help the people of Eastern Europe to pull themselves out of the economic stagnation and the hopelessness of recent decades.

We can be sure that these events will alter the configuration of the world economy in profound ways. It is too early to predict whether they will lend new momentum to the growth in world trade or whether the world will now divide into regional trading blocs that are focused inwards. In either case, it will be important to press ahead with multilateral trade negotiations; above all, we will need to set mutually agreed rules for trade and investment in the 1990s.

Here, at the Economic Council of Canada, we are vitally aware of the degree to which domestic policy decisions are shaped by international forces. Nearly every project we launch has an international dimension, and we are gradually developing new analytical tools to extend our knowledge of international commerce and its impact on Canada. Some of the preliminary results of our project on Competitiveness and Trade Performance are on page 7.

We believe it is essential that Canadians learn more about the success of the Pacific Rim countries, to understand how business is reorganizing production on a global basis and to explore the ways in which newly industrialized countries are using technology to enhance their competitive advantage.

One key aspect of Canada's comparative advantage is the design of the tax system. The proposed Goods and Services Tax is part of a strategy to modernize the tax system in order to gear up for competition in the 1990s. By eliminating the tax on business inputs, the GST will tax exports and imports in a more even-handed way. And, as a result, the Council's assessment of the GST shows a dramatic increase in exports over the next 10 years. However, our assessment of the tax as proposed in August indicated that a 9-per-cent rate also risked destabilizing prices and costs in the short to medium run. Hence, the argument in favour of a lower rate, which is laid out on page 4.

While it is essential to think globally in the 1990s, we must also focus some of our energy on local issues. In particular, how can the disadvantaged regions of the country cope with the centralizing forces of global production and trade patterns? The Council is now in the process of collecting the experience of local development initiatives across the country in order to get a better handle on how communities can promote economic development in an increasingly competitive environment. The Council project is described in Dialogue on page 14. The report of a seminar given by Douglas House, the new chairman of the Newfoundland's Economic Recovery Commission, provides new insights into the way outport communities weave their lifestyle around the land, the sea, and the unemployment insurance system. We think it is important to probe these local stories in the search for clues that will enhance local development even as we adapt to global forces.

These global forces were exhilarating in the last days of the 1980s. The 1990s will certainly bring us all new challenges.

The Council's view on GST

A lower rate and a broader base

One government proposal dominated public debate during the fall of 1989 – the Goods and Services Tax or GST. Put forth by the Minister of Finance in August 1989 and scheduled to take effect on 1 January 1991, this tax would replace the current federal Manufacturers' Sales Tax (MST) and the current Tax on Telecommunications Services (TTS). The debate aroused strong feelings from all sides, as evidenced by the numerous (and sometimes sharply critical) briefs presented to the House of Commons Finance Committee.

The most frequently cited objection to the August proposal was the 9-per-cent rate. Time and time again, those who appeared before the Finance Committee in the fall of 1989 suggested that the 9-per-cent rate should be reduced to 7 per cent or less.

Responding to this, the government acknowledged in December 1989 that prudence called for a lower rate. In a mid-December statement, the Minister of Finance indicated "The GST rate will, therefore, be reduced to 7 per cent."

This issue of *Au Courant* spotlights the GST and the Council's analysis of it. The Council's work was reported in two submissions to the Finance Committee (dated 27 September and 26 October 1989), and in a technical paper prepared by Ross Preston, senior research director, and Haider Saiyed, senior economist.

Early on during the debate, the Economic Council made it clear that its preference was for both a lower rate and a broader base. While agreeing that the GST would help make the tax system more efficient, the Council believed that a rate of 9 per cent was too high. The Council also believed that the GST should be accompanied by a well-designed system of tax credits to help undo the regressive nature of a flat-rate consumption tax.

Some aspects of the debate regarding the proposed GST tended to ignore or overlook the reasons behind the government's decision to replace the MST, a tax that has been on the books since 1924. In fact, the debate often lost sight of the basic purpose of this important initiative – i.e., the retooling of an out-of-date federal indirect tax system.

While the tax experts are likely to be familiar with the pros and cons of the GST, Canadians who have for years paid the MST on everything from automobiles to toothpaste found it difficult to buy the retooling argument. In many instances, individual Canadians preferred to participate in the debate by dwelling on specific or personal aspects of the tax. In the extreme, this new tax was acceptable as long as one was exempt from its effects.

The proposal to revamp the MST is an important component of the government's overall fiscal reform package. Combined with reform of the individual and corporate income tax systems (Phase I of tax reform), which included the replacement of deductions with credits on the tax form for individuals, sales tax reform (Phase II of tax reform) is aimed at producing stronger economic growth and a fairer tax system in Canada.

Disadvantages of the GST

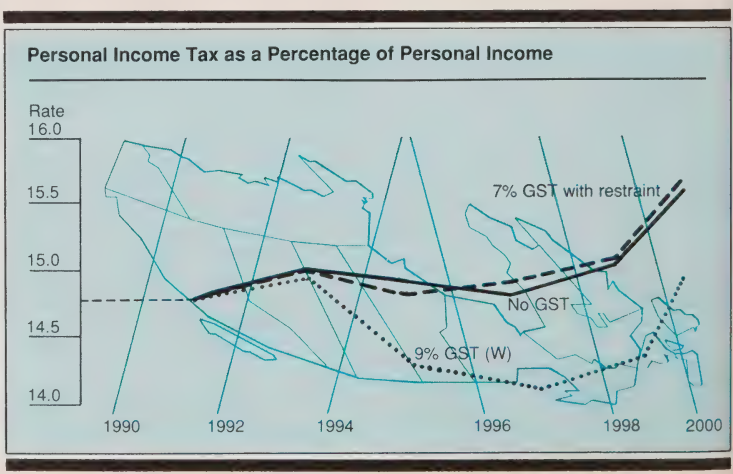
Most specialists, including those in the Department of Finance, agree that the MST has major disadvantages. For one thing, its base is far too narrow. Many industries are exempt from the current tax, which means that a wide range of manufactured goods are treated in a blatantly discriminatory manner. In fact, no less than 22,000 special provisions and administrative procedures exist for a tax system that applies to only 75,000 businesses. Increasingly, many tax specialists had visions of a haemorrhaging tax base, that no longer could be relied upon as a revenue source at a time when deficits loomed large.

In addition, the MST hurts exports, helps imports, and taxes capital inputs. Taxing the income from capital is appropriate, but taxing the value of capital rather than its return is not appropriate in the eyes of most experts on taxation.

In its 1987 Statement entitled *Road Map for Tax Reform*, the Council drew attention to the economic distortions caused by the variations in the sales tax rates applied to different commodities. It noted that applying different rates to various manufactured goods amounted to a discriminatory practice.

The Statement also noted that the MST acts more like a selective excise tax, with over 60 per cent of its yield drawn from only six commodities. Varying MST rates lead to distortions in investment and savings decisions, which in turn inevitably reduce economic efficiency.

Another major drawback of the MST is that the consumer is generally unaware that he/she is paying the tax. As Judith Maxwell, Chairman of the Council, pointed out to the House of Commons Finance Committee, this complicates the job of winning public acceptance for the GST. Canadians already unknowingly pay about $16 billion in federal sales



taxes every year. One of the objectives of fiscal reform is to make taxation visible. Given the invisible nature of the MST (since 1924), it is not surprising that the idea of a value-added tax such as the GST is not at all popular.

Yet it was not the visibility of the GST itself that raised the strongest objections before the Standing Committee; it was the height of the rate itself and the fact that this new tax would be levied on twice as many goods and services as the old MST. In particular, it would tax many services for the first time.

The GST and its objectives

In tabling its proposed multi-staged value-added tax, the government laid out three objectives:

– revenues from the GST would be much more reliable than the revenue generated under the MST and thus help the government to maintain funding of the programs and services to which Canadians have grown accustomed;

– the GST would be a cornerstone of the government's program to enhance Canadian competitiveness in the new global economy;

– the GST because of the system of income tax credits would make the tax system fairer.

The principle of a value-added tax that effectively exempts business inputs is not new. Multi-stage tax collection is common today having been implemented in 48 countries throughout the world. To date, 19 of the world's 24 industrialized countries have implemented a tax system of this kind in one form or another.

The proposal submitted by the Minister of Finance in August 1989 envisaged broadening the tax base to include a larger number of goods and services, while still exempting some consumer products (for example, food, prescription drugs, and health-care services). The government also promised a major redistribution program involving both spending and revenue transfers to Canadians of some $5.4 billion, plus another $1.5 billion in rebates for housing and small business. Thus the GST at 9 per cent would generate $24 billion (in 1991 dollars), of which $18.5 billion would replace the MST.

To assist those most likely to be adversely affected by the GST – low-income workers and those on fixed incomes – the government proposed compensation in the form of refundable tax credits. In short, the new GST system relied on the credit system introduced in Phase I of tax reform to ensure the fairness of Phase II of tax reform. In this sense, Phases I and II would work together to improve efficiency, lower rates of taxation in selected areas, and ensure fairness in areas where rates of taxation are to increase.

It was the judgment of the Council that the cost of the program of exemptions and redistribution was high. Among the consequences, the exemptions made the GST much more complicated and the combined exemptions and the redistribution program led to a higher rate for the GST than most taxpayers had anticipated.

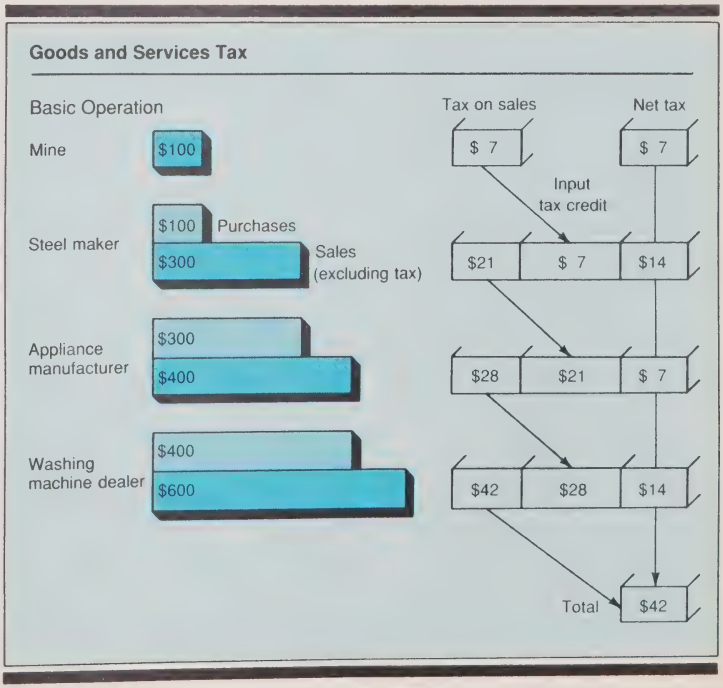
The effect on the economy

Nevertheless, by virtue of its greater visibility and its applicability to the added value of commodities rather than their total input cost (unlike the current MST), the GST would have a beneficial impact on the economy.

According to the Council, when the 13.5-per-cent tax paid at point of origin on manufactured goods is replaced by the GST, the price of manufactured goods will drop. Services, originally exempt from federal tax, will now be subject to the GST, and their prices will rise.

Under the new price regime, Canadian manufacturers and other large-scale users of Canadian equipment and machinery will become more internationally competitive. Exports will rise, imports of manufactured goods will drop, and both the merchandise trade balance and the current-account balance will improve. Finally, increased export and domestic sales will lead to increased savings and investment. A process of capital upgrading will occur, which will raise productivity and stimulate economic growth.

In sum, the GST will contribute in the long run to greater dynamic efficiency in



the economy, and thus to higher rates of economic growth.

However, following up on the concrete proposals contained in the August 1989 paper, the Council's research indicated that the proposed rate of 9 per cent would produce a short-term one-time blip in inflation of about 2.7 per cent. According to the Council's analysis, the "flashpoint" at which higher prices imparted by the GST would begin to pump inflation into the economy occurs when the GST rate was set above the 6.5 to 7.5-per-cent range.

With inflation already anticipated in 1991 in a range near 4.2 per cent without the GST, this meant the annual inflation rate in 1991 under a 9-per-cent tax regime would be as much as 6.9 per cent. How labour markets might react to this bubble became a critical factor in the debate as did the possible response of the Bank of Canada. The bubble itself, the reaction of labour markets, and the stance of monetary policy came to be known as the "transitional issues."

The prospect of an inflationary bubble and the uncertain reaction of both labour markets and the Bank of Canada to this bubble led Chairman Judith Maxwell, in her presentation before the House of Commons Finance Committee, to propose a lower rate, namely 7 per cent, in order to even out the impact of this new tax upon the economy during the so-called "transitional" phase.

At the same time, the Council's research demonstrated clearly that one of the major hurdles to be overcome in reducing the rate from 9 to 7 per cent would be a $1.8-billion reduction in the revenue collected. The Chairman pointed out that this revenue shortfall could be dealt with by implementing a phased freeze in government spending.

Different scenarios

Of the many scenarios (18 to be exact) investigated by the Council, one featured a 7-per-cent GST with additional expenditure cuts. The results of this scenario show that the 7-per-cent GST with spending restraint smoothes the entire economic response to the new tax, while strengthening real GDP growth. Inflation in 1991 is contained at 5.2 per cent.

The overall impact of the tax on relative prices and the negative impact on services are less pronounced. The favourable effects on the terms of trade remain. As against the 9-per-cent base case, real wages are much improved.

Even at 7 per cent, the growth of federal tax revenues speeds up in the long run. By the end of the decade, the federal budget deficit is $6.5 billion lower than in the MST base case.

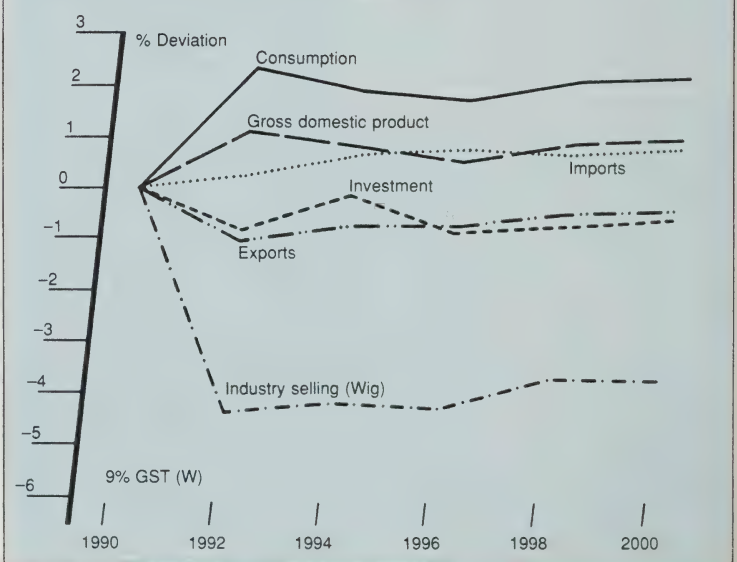
The idea of combining a lower rate with spending cuts follows directly from the Council's analysis of deficits, which is contained in *Legacies*, in its 26th Annual Review. In *Legacies*, the Council presented a scenario for reducing the deficit by means of a two-year spending freeze in five designated areas (capital assistance to business, subsidies to business, transfer payments to the provinces, the indexing factor for family allowances, and the hiring of federal public servants). Under this plan, the federal deficit would fall by some $3 billion by the end of 1992.

The Council also urged a reduction in the rate in order towards a framework that the provinces could join. In addition, broadening the base would eliminate much of the complexity associated with the GST and would create a more solid base of support for tax reform.

In the end, the government chose a 7-per-cent rate and covered the revenue shortfall through a combination of spending cuts and increases in corporate, personal, and excise taxes.

Not all issues surrounding the implementation of the GST have been resolved. For example, there remains the question of provincial participation. Nevertheless, the macroeconomic issues relating to the inflationary bubble have been resolved by changing the mix of spending and taxation in a way which is perhaps least injurious to the macroeconomy. Reducing the inflationary impact of this tax is perhaps the biggest contribution of the debate to date. In effect, a needless clash between monetary and fiscal policy will be avoided.

Relative Price Changes Induced by 9% GST
Selected Final Demand Prices and Manufacturing



The Pacific Rim countries

A great opportunity for Canada

The Pacific Rim countries are increasingly attracting the interest of the world's industrialized nations. During the last 25 years, this corner of the globe has engineered an economic recovery which is without precedent anywhere in the world.

Beginning with Japan, then Hong Kong, Singapore, Taiwan, South Korea, and, more recently, Malaysia, Indochina, Thailand, the Philippines, and even China, the world export shares of these countries have increased dramatically. The vigour of Asian industrial structures and their ability to assimilate the latest techniques of high value-added production have made these countries leaders on global markets.

As a result, Canada is well aware of the need to maintain and improve its international trade performance and it is particularly interested in the enormous potential of the Pacific Rim. The Economic Council of Canada started a research project on export markets and Canadian competitiveness, undertaking to analyse the vast possibilities of this region and the many challenges that Canada faces as it tries to take advantage of them.

One of the economists working on this project, P. Someshwar Rao, prepared the following text for *Au Courant*.

Canada and the Pacific Rim countries

The fastest-growing economies in the world are those of the Pacific Rim. As we approach the 21st century, these countries offer immense potential as a target for Canadian exports.

Canada's success in expanding its trade with this exploding market will depend critically on its ability to broaden its export base and to carve out a larger market share in the high-technology sector.

Canada will not find it easy to achieve these objectives. If it is to have any hope of competing successfully against the United States, Japan, and the Pacific Rim countries, it must first substantially improve its productivity and cost performance.

Canada must also arrest the erosion that is occurring in markets where it traditionally has been strong: resources and agricultural products. Competition is being felt in these areas mainly from the United States, China, Australia, New Zealand, and the member countries of the Asean, or Association of South-East Asian Nations.

The Pacific Rim

There are good reasons why the economies of this region are expanding so vigorously. These countries possess a number of key advantages, including:

- high savings and investment ratios;
- an educated, skilled and highly motivated work force;
- well-developed transportation and communication infrastructures;
- an outward orientation with respect to foreign trade and investment; and
- economic policies specifically tailored to market expansion.

Combined with a favourable global economic climate and a worldwide trend towards trade liberalization, the above factors have set in motion a virtuous circle where export expansion cycles, rising productivity, higher real incomes, greater industrialization, and increased investments in human and physical capital all serve to reinforce mutual growth.

The result is a remarkable record of output and productivity growth that has led to real per-capita incomes rising at a substantially faster pace in these Asian countries than in the United States, Canada, and other industrialized nations. The gap separating these countries from the major industrialized nations has also narrowed significantly in the past 25 years.



Someshwar Rao

In 1960, for example, per-capita incomes in Hong Kong and Singapore stood at about 25 per cent of U.S. levels. Today, the same workers are earning approximately 70 per cent of U.S. workers. While the growth in per-capita incomes in the other countries of the Pacific Rim is not quite so impressive, they too have shown remarkable improvement.

Over the last 25 years, first Japan and then Hong Kong, Singapore, Taiwan, and South Korea have become major players in world exports of manufactured

Regional Distribution of Canadian Exports and Imports, 1971 and 1987

	Exports		Imports	
	1971	1987	1971	1987
	(Per cent)			
Region/country:				
United States	68.4	76.0	70.5	65.0
EEC	14.5	7.6	12.4	13.0
Japan	4.6	5.4	5.4	7.1
Asian NICs	0.5	2.1	1.4	5.3
Asean countries	0.4	0.6	0.2	0.6
China	1.2	1.2	0.1	0.7
Rest of the world	10.4	7.1	10.0	8.1
Total	100.0	100.0	100.0	100.0

products. Their exports jumped from U.S. $31 billion in 1971 to more than $508 billion in 1987, an increase of more than 1,500 per cent. From 11.5 per cent of the world export market in 1972, the Pacific Rim countries now account for almost 20 per cent.

This represents a record of expansion unequalled by any industrialized country.

The challenges for Canada

The emergence of the Pacific Rim as a major centre of manufacturing production offers tremendous trading possibilities for Canada. But to take advantage of these opportunities, several daunting challenges must first be met.

The Pacific Rim countries are inevitably at the centre of policy discussions about trade, technology, foreign investment, and structural adjustment in Canada and elsewhere. This is because the burgeoning economies in this part of the world provide Canada with considerable potential for expanding and diversifying its commercial relations.

In terms of future trade, Canadians will continue to benefit from the high-quality, low-priced goods offered by these countries. On the other hand, many of Canada's labour- and medium technology-intensive industries will face increasingly fierce competition on both domestic and foreign markets from the Asian newly industrialized countries, the countries of South-East Asia, and China.

The composition of Pacific Rim trade

The commodity composition of exports from the Pacific Rim countries has changed markedly during the past 25 years, largely reflecting the rapid pace of industrialization and economic development in these countries.

Technology-intensive and "value-added" products now account for 50 per cent of Pacific Rim countries' exports, compared with only about 35 per cent in 1971.

And while Canada and the United States absorb almost 40 per cent of total exports from the Pacific Rim, these countries in turn purchase only 20 per cent of their imports from North America.

In contrast, the trade and investment linkages among the Pacific Rim countries themselves have grown markedly during the last 20 years. For instance, the intra-Pacific region share in total imports of that part of the world is close to 50 per cent today, compared to 33 per cent in 1971.

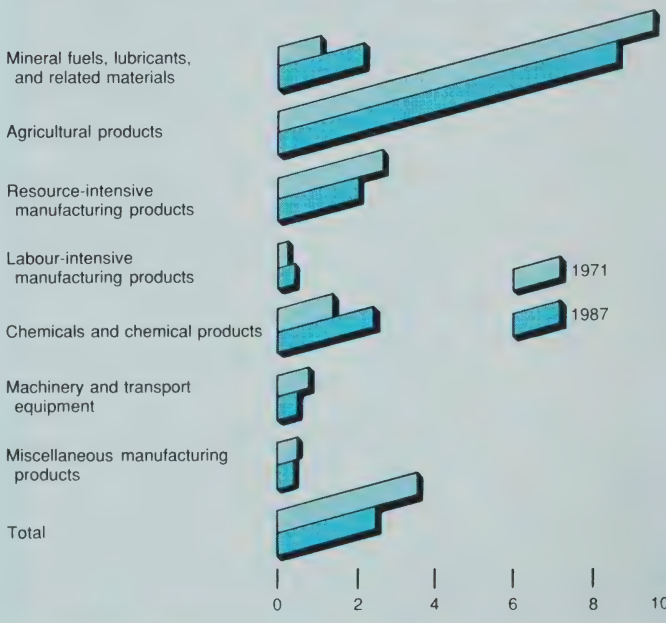
Trade between Canada and the Pacific Rim countries

Between 1971 and 1986, the increased trade between Canada and the Pacific Rim countries benefited primarily our Asian partners. While Canadian exports to these countries rose from 6.7 to 7.9 per cent during this period, their exports to Canada doubled, from 7.1 per cent in 1971 to 14 per cent in 1987.

The types of products imported and exported cover a wide range. Almost 50 per cent of Canadian exports are resources and resource-based manufactured products. More than 80 per cent of Asian exports to Canada, on the other hand, are in the high-technology sectors. This is yet another indication of how successful these countries have been in concentrating their production on high value-added products.

Trade with Japan, to take a more specific example, has risen from U.S. $1.7 billion in 1971 to more than $11 billion in 1987. Japan accounts for over 60 per cent of Canadian exports to the Pacific region. Despite these increases, however, Canada's performance in the Japanese market has been disappointing – its market share declined from 5.4 to 3.8 per cent between 1971 and 1987. An even more telling statistic is that Canada's share of Japan's imports of machinery and other equipment, a sector marked by rapid growth, was barely

Canadian Share of the Asia Pacific Rim Countries Imports, by Major Commodity Group, 1971-87





0.8 per cent in 1987. It was at the same level in 1971.

On the other hand, Canada's imports to the newly industrialized countries (Hong Kong, Singapore, Taiwan, and South Korea) grew strongly over the same period, jumping from U.S. $0.1 billion in 1971 to $2 billion in 1987. Yet, again, Canadian imports from these countries increased even more dramatically. In 1971, barely 1.4 per cent of Canadian imports were from these countries, but by 1987, this figure was 5 per cent.

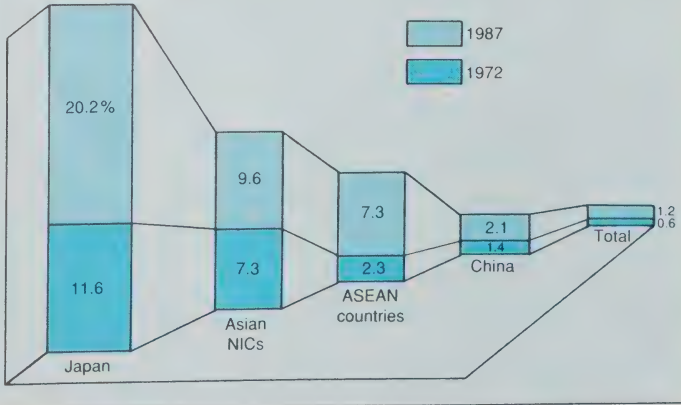
Resources and resource-based products again dominate Canadian exports to this region. These products accounted for 80 per cent of Canadian exports to Taiwan and South Korea in 1987.

In contrast to its loss of market share in Japan, Canada has managed, slowly but surely, to increase its market share of the other Asian countries, from 0.7 per cent in 1971 to 1 per cent in 1981 and 1.5 per cent in 1987.

Canada's trade with countries such as Malaysia, Indochina, Thailand, and the Philippines pales by comparison with its Pacific Rim trade. No more than 0.6 per cent of Canadian exports are destined for these countries. However, Canadian imports from these countries have been growing steadily and, as of 1987, they represented 0.6 per cent of total Canadian imports.

While Canadian exports to China have grown substantially in recent years, Canada's share of the Chinese market has been shrinking. From 13 per cent in 1971, it fell to 5.7 per cent in 1981 and to 3.3 per cent by 1987. The main reason behind this slide is the United States, which has come to dominate the Chinese market for machinery and other equipment. Canada, unfortunately, has had little success in broadening its trade base with the most populous nation on earth.

Market Shares of Asia Pacific Rim Countries in World Exports of Goods



Small coastal villages in Newfoundland

The role of unemployment insurance

An arsenal of national statistics and polling methods is not enough to understand the role of unemployment insurance in small Canadian communities. Case studies showing how unemployment insurance operates in local economies are also needed.

That is the task undertaken by Douglas House, former Director of Research for the Institute of Social and Economic Research at Memorial University in Newfoundland. House, who is now Chairman of the Economic Recovery Commission of Newfoundland, found that residents of small coastal villages in Newfoundland viewed the UI system as a sort of guaranteed annual income that they must "earn."

Despite gloomy economic statistics, these villages are vibrant communities. Community spirit and self-sufficiency linked to the UI system ensures residents a standard of living that compares with those of many city dwellers in Canada.

The system is not without faults and House says that it sometimes hampers the development of these communities. *Au Courant* summarizes below a recent presentation that House made at an ECC seminar.

Living on the periphery of North America, the residents of small Newfoundland outport villages have managed, despite difficult economic conditions, to belie the somewhat depressing picture painted by official statistics and to carve out a standard of living that rivals that of many urban Canadians.

Their method of doing so, however, is different from the mainstream: a sense of community sharing and family self-sufficiency, particularly when it comes to housing, cash income from seasonal employment in primary industries, mainly fish harvesting and processing, and supplemented by unemployment insurance.

Douglas House, a well-known Canadian economist, reports that his research among villages located in the northern peninsula of the province has led to his discovering a number of vibrant local communities whose efforts, he feels, deserve our respect and encouragement.

At a recent seminar on regional development organized by the Economic Council of Canada, House used case studies to illustrate how the residents of these villages (like, no doubt, residents of small communities all across Canada) have managed to turn unemployment insurance into a "reasonably" satisfactory income security system. In these circumstances, unemployment insurance has become a kind of guaranteed annual income that people have to "earn."

House feels that the UI plan is not without its shortcomings, however, in that it sometimes impedes development in these outport communities.

According to House, the people in these areas consider unemployment insurance as a resource, similar to other available resources such as fishing and tourism. While the majority of Canadians organize their lives around a career, the citizens of these villages, faced with a lack of local opportunity, find what work they can, when and where they can. By working sporadically for various periods, even if only in short spells, they succeed in qualifying for unemployment insurance or for increases in their benefits. In this way, House discovered, total household incomes are sometimes twice as high as incomes from paid employment.

According to House, it is important to understand the dynamics of the local community, which aims to ensure that as many citizens as possible qualify for unemployment insurance. Workers in the various communities stick closely together, even to the point of passing up employment opportunities in order to allow a village neighbour or friend to attain UI eligibility. Often, in fact, there is a collective effort to provide a large number of citizens with basic incomes that, while not that high, are still enough to purchase a good range of consumer goods.



Douglas House

"Thanks to a well-developed sense of community, the residents enjoy a wide range of free or very inexpensive services."

Household production

House points out that the residents of outport communities demonstrate a remarkable ability to keep housing costs down and to attain a wide range of services at low cost.

They construct, renovate, and maintain their homes by themselves. Despite the gloomy economic statistics for these regions, the percentage of family-home ownership is higher in Newfoundland

than anywhere else in Canada. By building their homes themselves, people manage to keep mortgages low. Local taxes are also lower here than elsewhere in the country.

Many residents cut their own firewood and heat their homes very cheaply. They also supplement their store-bought diet through hunting, fishing, and making preservatives gathered while berry-picking. They also do many of their own mechanical repairs.

Thanks to a well-developed sense of community, the residents enjoy a wide range of free or very inexpensive services. A woman who finds a job in a fish plant, for example, will likely arrange to have her children looked after by a family member or friend without charge. In the same way, the construction of a house often becomes a collective project, everyone pitching in to help his neighbour.

This capacity for self-reliance in the form of what House terms "household production" enables residents to enjoy a standard of living higher than their official incomes would suggest.

"Cash" income is used not only to buy consumption goods, but a portion is also directed to purchases of equipment such as freezers, snowmobiles, tools, and construction materials that are used to generate wealth in household production.

Aside from the unique aspects of their local economy, the citizens of Newfoundland outport villages enjoy a lifestyle that is similar to the majority of Canadians. More than half, notes House, have a truck and a car. More than half also have a boat, and sometimes two. Two thirds of them have VCRs, and one or more televisions. One hundred per cent have a refrigerator and over 84 per cent a freezer.

Failings of present system

According to House, there are nevertheless a number of shortcomings in the present UI system. For example, it encourages workers to decline part-time or casual work out of fear of compromising their eligibility for UI benefits. Workers may sometimes forego opportunities to further their education in order to accept jobs that will ensure their UI eligibility in the off-season.

House claims the system discriminates against self-employment and small business entrepreneurship, since workers risk compromising their UI eligibility by such initiatives, and self-employed people are not eligible for unemployment insurance. He finds that workers are unwilling to strike out on their own unless they are certain to receive good incomes right from the start – a remote prospect for a fledgling business.

Thus, continues House, the UI system represents both a blessing and a curse for the residents of these areas.

While it acts in some ways as a guaranteed income plan, the system's failings nevertheless mean that it contributes to economic stagnation in the region. It remains a system that shackles people to established ways of organizing their lives and their economy.

House concludes, however, that the answer to these problems certainly does not lie in lower benefits. What is needed instead is an income security system designed to support, rather than to discourage, the initiatives of local people to improve their economic circumstances.

"Workers may sometimes forego opportunities to further their education in order to accept jobs that will ensure their UI eligibility in the off-season."



Getting our act together

Council Chairman Judith Maxwell spoke recently about the transition taking place in our financial institutions at the Financial Post Conference in Toronto. She talked more specifically about the overlapping and conflicting regulation of our financial system, a luxury we can no longer afford. Following is an abbreviated version of that speech.

From the beginning, financial legislation in Canada has been a patchwork quilt. Because of the way powers are imbedded in the Constitution, federal and provincial governments share the responsibility for regulating financial institutions.

Fragmenting jurisdiction in this way has had some advantages. Nevertheless, we have paid a price for this diversity.

The problem

The cost of overlapping and conflicting regulations were a luxury that Canadians could afford in an era when the distinction between the pillars was clear-cut, when financial intermediation was less important, when domestic markets were more or less isolated from international markets, and when financial transactions were transparent. Those days are gone.

On the domestic front, the erosion of the pillar system, which has intensified since the beginning of the 1980s, has meant that the various categories of financial institutions fulfil similar roles. Yet their activities remain subject to different legislation and monitoring systems, even within the same jurisdictions.

There have also been major shifts in the nature of financial activities. In Canada, these changes are reflected in wider international circulation of capital, increasing volumes of international issues, the establishment of foreign institutions, and greater diversity in currency use.

Our research on internationalization shows that it has brought benefits; to borrowers – seeking cheaper sources of funds; to savers and portfolio managers – looking for better investment opportunities; and to financial firms – wishing to expand and diversify beyond their national borders.

Increased benefits are rarely free, however. For financial institutions, moving into foreign markets has entailed a new and different set of risks.

The combination of internationalization and financial innovation has reduced the transparency of the financial system.

Finally, differing requirements may discourage foreign firms from establishing in Canada. Canadian investors and borrowers then lose the benefits of increased competition that flow from the entry of new actors into the market.

In light of these considerations, the Council believes it is crucial for Canada's regulatory authorities to get their act together to minimize the problems generated by our fragmented jurisdiction.

Alternative solutions

There are at least two possible cures for fragmentation. The first, which involves surgery, is to eliminate overlapping responsibilites by assigning specific categories of institutions and types of activities to specific governments. The second, which does not require surgery but does assume long-term therapy, is a serious commitment to coordination and harmonization.

Realistically, we should try to harmonize legislation rather than homogenize it. The European experience demonstrates that uniformity of legislation is an elusive goal for an economic federation or union comprising more than a few members. As long as the European Community espoused the philosophy of uniformity and centralization, nothing much happened. The situation began to change in 1985, with the adoption of the Single European Act, which set out the dual goals of "minimal harmonization" and "mutual recognition." This new approach recognized the individuality of each member country. It led to the establishment of minimum standards.

These principles could be applied to the Canadian situation. Agreement on basic standards for investment powers, capital requirements, related-party transactions, and distribution of financial products would ensure that no player could accept excessive risk or could engage in fraudulent activities by profiting from loopholes in the system. The principles would also allow financial institutions to operate from coast to coast, according to mutually recognized standards of security, while granting the provinces the right to maintain legislative arrangements aimed at meeting local needs. But to make it happen, we will have to establish an official forum where the 11 jurisdictions and all their regulators can get their act together.

We have a long way to go to get there.

It seems that the only way to build confidence among all the players on the field in this complicated country of ours is to create an agreed set of rules of the game and then delegate the task of inspection and supervision to individual players. If the 12 European nations can do it, so can we.

In summary, if Canada is going to profit from the advantages offered by the globalization of financial markets, it has to hold risks to manageable levels. I think Canadian regulators can manage these risks, if they make a commitment to harmonization and coordination.

"If Canada is going to profit from the advantages offered by the globalization of financial markets, it has to hold risks to a manageable level."

Agriculture in the Prairies

A need for policy review

Council Deputy Chairman, Caroline Pestieau, spoke recently on the subject of farm policies review at the Canadian Agricultural Finance Conference held in Winnipeg. Following is an abbreviated version of that speech.

Agriculture is one of the main issues in the current Uruguay Round of Multilateral Trade Negotiations. This gives it a much higher profile on the G-7 agenda and on national agendas that it has had in the past.

While in the medium term we foresee the productive capacity of the food sector growing faster than effective demand, it is by no means certain that this will continue.

Moreover, it is important not to lose sight of the interdependence between the goods and services sectors. Goods producers are increasing the proportion of their expenditures devoted to services, and there is a close link between the two sectors. For every dollar spent in agriculture, about 20 cents are spent on services.

Since agriculture is here to stay and we live in an interdependent world economy, we are being forced to review our agricultural policies in the context of the GATT negotiations. The need to reduce income instability, to increase competitiveness, to get rid of federal/provincial frictions, to limit government expenditure, and to conserve the environment, all demonstrate the need to rethink our farm policies.

In its report on the Prairie grain economy, *Handling the Risks*, the Economic Council concluded that Canadians should share the uninsurable risks of agricultural production with the farmer.

There is a paradox that is familiar to all of us. The owner-operator – the very symbol of autonomy and independence in our society – has become so dependent on government that he is often accused of farming support programs rather than the land. The low point was in 1987 when support programs accounted for all realized net farm incomes in the Prairies. Meanwhile, in the supply-managed sectors, quota rights have become marketable commodities and are sometimes more valuable than land or equipment.

In the sectors not regulated by marketing boards, farmers have become dependent on commodity-specific support, such as the Western Grain Stabilization Program, and on emergency measures, such as the Special Canadian Grains Program. In some cases, the distortions caused by these measures provoked compensatory action by federal or provincial governments. One result of this "ad hocery" is the unintended pro-wheat, anti-livestock bias in several federal Prairie farm programs. Such a policy maze also obscures market signals and discourages farmers from exploring new markets.

The numerous federal and provincial programs facilitating farmers' access to credit are another example. It is now clear that easy money is not an unmitigated benefit to farmers.

The Council's work shows that farming, at least in the Prairies, has become riskier than it was in the early postwar period. Our work shows a wide range in cost effectiveness between different Prairie producers. Higher production costs and poor management often prevent producers from reaping the expected benefits of diversification.

All this tells us that farmers require a much higher level of financial and general management training and support than used to be the case. The need for better quality education and training is a common cry across the Canadian economy. Farmers and prospective farmers must be included in any action on this front. It is important to all of us that this training take place since we are sharing in or "socializing" farmers' risks.

I believe that well-trained farm managers should be the senior partners in the sharing of risks with governments in Canada. I suggest that the role of public policy is to return the initiative to the farmer and then socialize part of his/her risks, rather than providing commodity-specific support or sponsoring new market endeavours. Risk sharing leads us to examine the design of safety nets.

A good safety net should reduce farm income instability, strengthen market signals, and encourage cost-effective managers. It must provide for emergency relief in times of disaster but still facilitate movement out of farming when economic circumstances require it. One of the Council's senior economists, Dr. L. Auer, has developed a farm income insurance system with these features. (See *Au Courant*, Volume 10, No. 2, 1989, "A more even-handed program.") It has some similarities with other recent proposals for decoupled income support. There are, however, differences. The program we have developed and simulated would cover all Prairie farmers. Farmers and taxpayers would share the costs equally. We have calculated that such an income insurance program initiated in 1966 would have allowed Prairie farmers to build up substantial cash holdings in their stabilization funds. Such a program would have enabled farmers to manage their own responses to the crisis of 1986-88 – absorbing price declines while continuing the same activities, specializing, diversifying, or quitting farming.



Caroline Pestieau

There are many open questions regarding Canada's agricultural programs. There are also constraints limiting our policy choices. Nonetheless, I am greatly encouraged by the atmosphere and circumstances surrounding the current policy review. International and domestic pressures seem to be converging to help us design a framework for a set of efficient, affordable, and coherent farm support policies.

"Local development," a new approach

Regional inequalities – how to eliminate them or at least reduce them – have long been one of Canada's principal economic concerns. Over the past 20 years or so, many different regional development initiatives have been tried, with (as even the experts admit) rather limited success. The reason for this lack of success, however, is a subject of debate.

In recent years, a new formula has emerged: "local development." What exactly does that imply? What makes the "local development" approach different from the others? What is the relationship between social or cultural development and economic development efforts? Is it possible to develop policies that will give "local autonomy" a fair chance to succeed while maintaining reasonable standards of accountability for the user of public funds.

These are just some of the questions that the Economic Council of Canada hopes to answer in its research project on local development.

To find out more about this important undertaking, *Au Courant* interviewed economist and project director Tim O'Neill, the President of the Atlantic Provinces Economic Council.

Au Courant: *What are the main objectives of your research project?*

O'Neill: There are actually two phases to this project. In phase one, the focus was on case studies of actual local development efforts in Canada. In the second phase, we are adding a conceptual understanding of what local development means and what it could mean. We are also attempting to synthesize the information provided by the case studies and gathered from other studies on the subject. This will allow us to achieve the overall objective of both phases which is to assess the actual and the potential contribution of local development efforts to economic development in Canada. This phase then is designed to evaluate the available information and to provide some policy directions for public sector support of local community development.

Au Courant: *Did the policies instituted in the last 25 years to correct regional disparities have their intended results?*

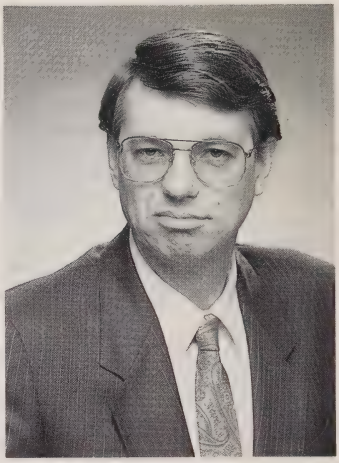
O'Neill: I think there is a general agreement that the attempts to deal with regional disparities have not had the intended results of reducing differences in key areas, such as unemployment rates and earned income levels. On the other hand, there is considerable disagreement as to why that is the case. Some have argued that policy intervention is wrong headed and that the best approach is to let the market take care of things by moving people out of underdeveloped areas into more-developed ones. Others have contended that policy intervention is appropriate but that it has not been extensive enough, or that it was not carried out for a long enough time period, or that we did not have the right mix of programs, and so on.

Au Courant: *What exactly is meant by local development?*

O'Neill: Local development can mean a variety of things. We have tried in this project to give it a very specific focus. We are looking at economic development as meaning economic growth combined with structural change which improves the well-being of people in local communities and regions in the country. It is local in the sense that we are talking about small geographical areas – often municipalities or small groupings of municipalities in which people have a common set of political, social, and economic institutions, and share common services and infrastructure. Although there are somewhat different views on this, local development has also come to imply that the community itself is involved in the direction of its own economic development.

Au Courant: *Is enough information already available on the various regions involved or will you have to carry out some research on your own?*

O'Neill: At the beginning, we were concerned that there was not sufficient information in the case studies alone, so we have had to supplement it with information from other works and from interviews that we have conducted with local development practitioners and government officials. We feel that we have enough information at this stage to give us some reasonable indication of both the type and the scale of contribution, and also the potential for further contribution of local development efforts.



Tim O'Neill

Au Courant: *Is there a danger of uneven results with a local development approach, given that regions are not equal in terms of resources, dynamism, and so on?*

O'Neill: There is already unevenness in development if you are comparing different local areas or different regions. In fact, the economic disparities within regions among local areas are more pronounced, more significant than differences between regions. There are many who view the local development approach as a way to reduce the unevenness by focusing on smaller geographical areas and by boosting those areas to bring them closer in terms of economic performance to more prosperous locals.

Au Courant: *What are the advantages of local development compared with other approaches?*

O'Neill: The knowledge in the local community of existing strengths and weaknesses and the capacity to tailor economic activities to the features of the local area is one type of advantage. As well, community development and groups, by involving themselves in the process of development, can spread the risk of investing economic development. This can be an encouragement to potential entrepreneurs in the community.

Au Courant: *Does local development touch upon other aspects of development?*

O'Neill: Actual local development efforts have tended in fact to involve other aspects such as social and cultural development. One of the questions that we are trying to wrestle with is the extent to which we should be looking at the contribution of those areas which are much more difficult to evaluate. Certain types of social development and perhaps even certain types of cultural development can have an influence on economic development. Since our focus is on economic development, we will consider how those other types of development support or complement the economic development of the community.

Au Courant: *Should local development funds be channelled into infrastructure development or rather directly into specific projects?*

O'Neill: We are leaning very strongly in favour of suggesting that public sector support for local development be primarily for building up local structures that will enable the community to foster development more effectively. We should be careful here because we are not really talking about traditional infrastructures such as water and sewer systems, roads, and industrial parks. We are thinking more about the institutional structures that need to be built up within the community. This type of institution can, for example, analyse prospects for development and engage in the information gathering and analysis required to be looked at for new market opportunities and new technologies. We are also inclined to suggest that programs of business assistance currently available at the provincial and the federal levels be modified so that local development initiatives have access to funding available for specific projects.

Au Courant: *Should development strategies and policies be uniform across the country or should they be individually tailored to the particular characteristics of the regions?*

O'Neill: Since many of the strategies will be formulated within the community itself, they will automatically tend to be tailored to the specific features of that locality. The real challenge is rather on the policy side – designing policies that are sufficiently flexible and broad to allow tailoring to occur.

Au Courant: *How much consideration is given to local autonomy in economic development?*

O'Neill: Literature produced by local development practitioners and discussions with the people involved in that "milieu" will show that quite a bit of emphasis is placed on local autonomy. The problem that we have had to deal with in the research report is to determine precisely what is meant by local autonomy. Does it mean local ownership or local control, or does it mean something less sweeping than that, such as local involvement in the development process?

The second issue is, what purpose local autonomy serves? If local autonomy means better prospects for development, if it is inherently superior to control from the outside, then of course it has an obvious benefit. But it is not clear that local autonomy, especially in its more sweeping versions, contributes significantly to the process of economic development. There are many cases of communities of various sizes that have survived and thrived with considerable ownership and control from "outside" the community.

"There is a general agreement that the attempts to deal with regional disparities have not had the intended results of reducing differences in key areas such as unemployment rate and earned income levels."

Au Courant: *Is the approach adopted by your research intended to complement or to take the place of existing programs?*

O'Neill: We are anticipating something of both. If programs for supporting local development activity are going to be expanding, the expansions will come, to some extent, at the expense of funding for existing programs. However, to the extent that local development efforts make existing approaches more effective or add an important missing ingredient to those programs, the impact will be complementary to existing efforts.

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Discussion Papers

Papers on Local Development

No. 1 "Loan funds for small business: Lessons for Canadian policy makers – A case study of Colville Investment Corporation," by *Lloyd I. Baron* and *Noel Watson* (also available in French).

No. 3 "Regional development in Atlantic Canada: An overview and a case study of the Human Resources Development Association," by *Elizabeth J. Beale.*

No. 4 "Where credit is due: A case study of the Eagle River Credit Union," by *John Wickham*, *Richard Fuchs*, and *Janet Miller-Pitt.*

No. 5 "A case study of the Kitsaki Development Corporation," La Ronge Indian Band, La Ronge, Saskatchewan, by *Michael Decter* and *Jeffrey Kowall* (also available in French).

No. 6 "The Great Northern Peninsula Development Corporation: An organizational framework for revitalization?," by *Peter R. Sinclair.*

No. 7 "The West Prince Industrial Commission: A case study," by *Wayne MacKinnon.*

No. 8 "Equity capital and economic development in Newfoundland and Labrador."

No. 10 "What we can do for ourselves: Diversification and single industry communities – The implications of a community economic development approach," by *Michael B. Decter*, and "The vulnerability checklist: A tool for community self-assessment," by the *Canadian Association of Single Industry Towns.*

No. 11 "The community as a base for regional development," by *Stewart E. Perry.*

No. 12 "Canadian regional development – The urban dimension," by *A.F.J. Artibise* and *Matthew J. Kiernan.*

No. 13 "Yukon 2000 – Comprehensive planning for diversification," by *Michael B. Decter* and *Jeffrey A. Kowall.*

No. 14 "Development indices: A Quebec regional comparison," by *F. Lamontagne* and *C. Tremblay.*

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Employment in the service economy

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Staffing Programs for Researchers

The Economic Council of Canada has launched two programs designed to provide researchers and highly qualified Ph.D. students with an opportunity to work, for a fixed term, with Council research staff on a variety of projects.

The first program provides a Ph.D. student whose thesis topic is relevant to the Council's research program with an opportunity to write his/her dissertation at the Council. The student will receive an assignment lasting up to two years with the possibility of a one-year extension in certain cases. The Council offers two positions of this kind.

The second program comprises two options. The first option, involving a term not to exceed one year, is aimed at professors planning sabbatical leave in order to pursue their research or to undertake new projects. The second option, involving a term of at most two years, is open to professors taking leave without pay, to public service professionals, to researchers from other institutions, and to other individuals with appropriate qualifications. The incumbent's responsibilities will combine research work with the provision of advice and counsel to senior management at the Council. One position is available for each of these two options.

Brochures describing each of these programs have been sent to universities and to most research centres across Canada. Candidates interested in obtaining additional information are invited to contact the Corporate Secretary, Economic Council of Canada, Post Office Box 527, Ottawa, Ontario K1P 5V6; telephone (613) 952-1712.

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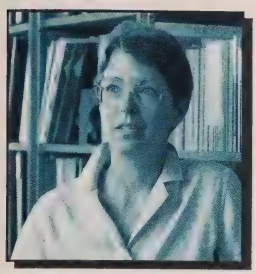
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Judith Maxwell

Discovering trends in job structure

In this issue, we report on *Good Jobs, Bad Jobs*, a Council Statement on Employment and the Service Economy. Our research has isolated several fundamental new trends in the economy which will have profound social consequences in coming years.

We have discovered, for example, that the job structure is becoming polarized into good jobs – with high pay and relative security – and bad jobs – with low pay and little security. This new structure has an important impact on the distribution of income in our society.

We have also discovered a powerful centralizing force in the new job structure which pulls the good jobs into the metropolitan areas, thus aggravating the urban-rural disparities that have long plagued Canada.

In addition, we have learned that the strongest force behind the growth of the service sector is the growing demand from resource and manufacturing industries.

While the project thus provides a new perception of the way labour markets and industrial production function, we are aware that there is a need for ongoing research so that Canadians will be able to understand better the causes and consequences of these new trends that are helping to define their lives. It is necessary to know, for instance, just how much mobility there is between the good and bad jobs. The social consequences of an economy where people are stuck in bad jobs for a whole lifetime will be very different from one where people spend a few years in a bad job.

These issues are of particular concern to women, as you will see in the report of a speech "The Economic Role of Women" which I delivered at an International Women Day Seminar at Statistics Canada in March. Women are overrepresented in the bad jobs category, and they run the most severe risk of being trapped in poverty. This has important consequences for the quality of their life and also for their children's chances of success in school and in later years.

The new geographic distribution of jobs – with the concentration of good jobs in the cities – also raises some interesting questions. We do not know, for example, to what degree technology will make it easier or harder for the peripheral regions of Canada to generate good quality jobs. Does technology provide the means to overcome distances, to get costs down and quality up? Or, is technology yet another element of the centralizing force that concentrates new jobs in the biggest cities?

We do not know the answers to these questions, but it does seem clear that resource-based provinces like Newfoundland and Prince Edward Island must master the use of the new technologies if they are to minimize the effects of these centralizing forces. And in our current projects on local development (see *Au Courant*, Volume 10, No. 3), we have identified several situations where economically depressed communities have used technology as the lever to develop a small but successful export industry.

One of the key messages from this study is that there are strong linkages between labour market policies and industrial policies. Competitiveness, which is a big preoccupation of so many Canadians these days, will be determined by the way managers blend production, marketing, and human-resource policies. One will not succeed without the others.

Other articles in this issue touch on industrial policy from a different perspective. In our *Dialogue* column, for example, we describe the work the Council has been doing to evaluate the contribution of mergers and acquisitions to economic performance.

As we hope to do in all our projects, *Good Jobs, Bad Jobs* has succeeded in putting new information and new insights into the public debate. I am pleased to see that it is already influencing the way policymakers are thinking about social and economic issues here in Canada. To me that is a sign that the Council is doing its job. It shows, once again, the power of ideas.

Trends in the service economy

No longer can prosperity come straight out of the ground; increasingly, it must come from the minds of the Canadian people.

In the late 1940s, 60 per cent of the Canadian labour force worked in the goods sector – natural resources, manufacturing, and construction. Today, barely one work life later, over 70 per cent of workers are employed in services.

And this dramatic shift in employment patterns is, if anything, accelerating. During the last decade, virtually all of the net job creation in this country took place in the service sector.

At the same time, another worrisome trend is emerging. The number of middle-income workers is declining and incomes are becoming more polarized around two quite distinct growth poles. One includes highly skilled, well-compensated, stable jobs, while the other – and this is the troubling aspect of the trend – consists of non-standard jobs with relatively low levels of stability, compensation, and protection. In fact, we can speak of "good jobs" and "bad jobs." Worse, it is most often young people, women, poorly educated workers, and older workers who are found in this category.

While many are clearly doing very well through employment, the bottom line is that there is less economic security for a declining share of fewer Canadians.

Adjustment needed

In its Statement entitled *Good Jobs, Bad Jobs*, the Economic Council of Canada offers a detailed analysis of employment trends in Canada in recent years and concludes that government policy and institutions have not kept pace with labour market developments. Consequently, adjustment is needed – and needed quickly. This challenge will demand the concerted efforts of governments, employers, unions, and the workers themselves.

The Council identifies three general and mutually reinforcing principles that must lie at the heart of any strategy designed to achieve high employment and to maximize the contribution of human resources in an economy where services play such a central role. These principles are as follows:

- strengthen the commitment to human-resource development;
- promote economic security for workers; and
- recognize the role of services in economic growth.

Jobs in the 1990s

The Council notes that the changing structure of employment should not be seen simply as the result of an expanding service sector. A number of other factors have played important roles, including fast-paced technological innovation, the information explosion, and economic globalization. Together with growth in the service sector, these factors feed the incessant demand for more highly skilled and educated workers.

The Council's analysis suggests that the Canadian labour market in the 1990s will be defined by the following features:

- slow growth of the work force, with an older age profile;
- increasing employment in service activities;
- more work with high knowledge content;
- concentration of "good" jobs in large cities;
- growth of non-standard employment forms; and, possibly,
- widening disparities in the quality of jobs and in the degree of economic security they provide for workers.

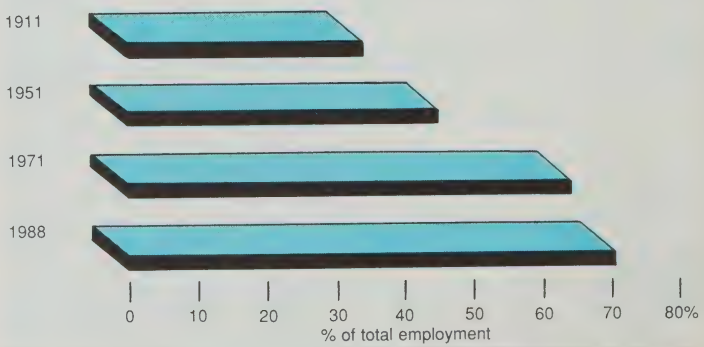
These changes will shape the education and training decisions of young people and the career patterns of the adult work force.

Increasingly, economic performance is closely linked to the human factor. Canadians should not expect to improve – or even maintain – their standard of living unless, as a nation, they attach a high priority to the quality of the work force. The Council argues that developing human resources through effective education and training policies is an investment in the future.

"Non-standard" forms of employment

Non-standard forms of employment include part-time jobs, short-term jobs, temporary-help agency work, and own-account self-employment. These jobs are often characterized by a degree of precariousness, i.e., they tend to be poor paying, unstable, and poorly protected.

The Growth of Service Employment, 1911-88



The rise in "nonstandard" jobs

Canadian workers' real incomes increased significantly during the late 1960s and early 1970s, peaking in 1977.

A decade later, real incomes have actually declined slightly. At the same time, earnings have become more polarized, shifting to the high and low ends of the wage scale. The result? The proportion of middle-income earners is growing smaller, and there has been a rapid expansion in non-standard, unstable and low-paying jobs, on the one hand, and highly specialized, well-paying jobs, on the other.

The declining middle

In 1967, 27 per cent of the Canadian work force had annual earnings that placed them in the "middle-income" category. By 1986, only 22 per cent of the labour force fell within this group.

This downward trend has made itself felt in all income categories and in all regions of the country, ranging from 4 percentage points in the Prairies to 8 percentage points in Ontario.

While the growing polarization in earnings applies to families as well, it is not as evident when the distribution of total income is considered – at least not since 1973. These results, notes the Council in *Good Jobs, Bad Jobs*, suggest that transfer payments are offsetting at least some of the increasing disparity in labour income.

The Council finds it troubling that, given the present context of large budgetary deficits and mounting public debt, the social safety net could be facing an increasingly onerous burden because of the growing disparity in employment incomes.

Non-standard jobs: part-time employment

The number of people in non-standard work forms have exploded in recent years. The most important type of non-standard work is part-time employment, defined as jobs with less than 30 working hours per week.

Part-time work rose from 4 per cent of total Canadian employment in 1953 to 15 per cent by the mid-1980s.

Since 1975, part-time work has accounted for at least 30 per cent of net job growth in every province except Alberta, Prince Edward Island, and Ontario. In Quebec and Saskatchewan, it has contributed no less than 40 per cent of new jobs.

Involuntary part-time employment – where workers would have preferred full-time jobs if they could have found them – has also been increasing and now accounts for 24 per cent of all part-time employment.

Most part-time workers are employed in the retail trade and personal services and the overwhelming majority are young or female (or both). By comparison with their full-time counterparts, part-time workers are much more likely to be short-term employees, to be employed in very small firms, and to be non-unionized.

Short-term work

Another type of non-standard employment, short-term work (jobs of less than six months' duration), is also growing. According to the Council Statement, most short-term workers are young; indeed, a significant number of them are full-time students. Short-term jobs are more likely to be part-time and to be situated in small firms. Short-term workers are less likely to be unionized or to be covered by a pension plan.

Self-employment

Another growing form of non-standard work is self-employment (or, more precisely, "own-account" self-employment, where there are no employees). Council researchers discovered that 10 per cent of overall job growth during the past decade has been in this category. The own-account self-employed are most frequently engaged in traditional services, which include a wide range of sectors – hairdressing, trucking, child care, snack food, moving, and so on.

While there is a high degree of variability, their earnings tend to be lower than those of workers employed by others. In 1986, more than half of the self-employed earned less than $10,000, compared with 27 per cent of paid workers.



Employment and Immigration

High technology contributes to economic growth.

Temporary help

Employee opportunities in temporary-help agencies have tripled in the 1980s and now stand at over 80,000. The Council Statement reports that, according to a 1988 survey, 41 per cent of such workers are engaged in this line of work because they could not find full-time jobs. Most temporary-help workers are in clerical occupations and about 70 per cent are female.

Not only are wage levels generally well below those for full-time workers, but fringe benefits are usually minimal.



The service sector covers a wide range of industries.

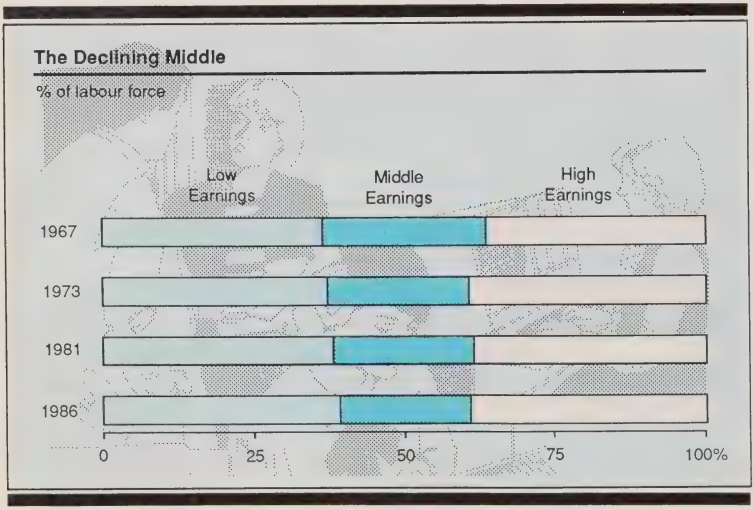
A subject of controversy

Between 1981 and 1986, these four forms of so-called non-standard employment accounted for about half of all new jobs. The increase in non-standard work has aroused a certain amount of controversy.

To some, this trend reflects the need for flexibility on the part of both employers and workers. The Council acknowledges that, in a context of rapidly changing market conditions, these forms of employment offer certain advantages. Certainly, some people consciously seek such jobs.

However, the Council's analysis shows clearly that non-standard workers generally earn less than others in full-time, more permanent jobs in the same occupations and the same industries.

The Council concludes, therefore, that the trend in favour of non-standard employment may be compromising the economic security of growing numbers of workers. In the long run, it may even have a negative impact on Canada's sense of community.



Refocusing

In impressing upon policymakers the need to take into account the new diversity of employment, the Council recommends that governments adopt legislation to require the inclusion of part-time employees, with an ongoing attachment to their employer, in all employee-benefit plans normally available to full-time employees. These part-time workers would receive prorated benefit.

The Council also recommends that awareness of the changing face of employment be systematically incorporated into the design of the various public benefit programs in order to ensure that workers in non-standard employment are not excluded from their benefits.

Finally, the Council urges governments to evaluate the adequacy of Canada's combined public and private pension systems in light of the marked increase in non-standard forms of employment.

What is the service economy?

In recent years, it has become clear that the neat distinction between goods and services is breaking down, that the two sectors are converging. An ever-larger volume of commercial, financial, and communication services, as well as others, is being packaged by manufacturers to form an integral part of the final product. Indeed, over the last decade, goods producers themselves have been responsible for much of the expansion that has taken place in the service sector.

The link between these two sectors has reached the point, according to the Economic Council in its Statement entitled *Good Jobs, Bad Jobs*, where goods and services have become vitally dependent upon each other.

Businesses in the resources and manufacturing sectors purchase and use services as "inputs" to their operations. Meanwhile, services help make resource and manufacturing industries more competitive by injecting "added value" into the final product.

Technological change is also blurring the conventional distinctive features of a growing number of service activities. Goods production itself is becoming more and more "service-like." Job growth in the goods sector is increasingly in white-collar occupations, which provide services such as administration, information collection and processing, research and development, marketing, and clerical work. As well, some recent innovations are endowing goods production with service-like features. The growing trend towards "bundling" training and maintenance contracts into equipment sales, for example, is also acting as a converging force.

The service economy

The service sector includes a wide range of diverse industries and can be organized into three subsectors, each with its own distinctive characteristics and employment patterns.

The first of these groups, the "dynamic" services, includes four major industry divisions. Two of these are distribution-oriented (transportation, communication, and utilities; and wholesale trade), and the two others are commercially oriented (finance, insurance, and real estate; and business services). These are high-value-added industries that have become more and more involved in internationally competitive markets. These services are becoming critical ingredients in the production and distribution of goods.

The "traditional" services subsector consists of retail trade, accommodation and food, and a wide range of personal services including haircutting, repairing, and amusement and recreation. These industries are traditional in the sense that they represent the old "Main Street" type of services.

The Council points out, however, that some significant changes are taking place within this subsector, most notably, the emergence of megacorporations. These are particularly in evidence in the restaurant industry, where they have introduced mass production technologies, inventory systems, and marketing techniques on a massive scale. A number of innovations have also appeared in retailing, such as self-service and at-home buying.

Despite these recent innovations, however, the traditional services remain largely isolated from the general trend towards globalization and still tend to operate in local or, at most, national markets.

The third and last subsector is composed of the so-called "non-market" services. They include workers in education, social services, and public administration. While competition has not traditionally been a significant factor in this subsector, the efficiency with which these services are produced has a direct impact on the required level of public financing.

Why has service-sector employment grown so rapidly?

It has been claimed that growing service-sector employment simply reflects the poorer productivity performance of this sector relative to the goods-producing sector, or that the demand for services has simply grown as incomes have risen and as more women have entered the work force.

The Council believes, however, that these factors have likely accounted for only a small part of the shift to services.

While acknowledging that identifying the reasons behind the rapid growth in service-sector employment is a difficult task, the Council argues that the driving force in this expansion has been a sharp increase in the demand for services as inputs to the production process.

Internationalization of services

Responding to the new opportunities offered by technological change, services have also been part of the global trend



Most temporary jobs involve office work.

towards internationalizing business activities.

The figures speak for themselves. By 1988, foreign direct investment by Canadian service firms exceeded that of manufacturers. Only a decade earlier, foreign investment by manufacturing firms was roughly four times that of services.

The growing Canadian presence abroad involves a wide range of services, including financial, accounting, engineering, and computer services.

While the direct impact of trade in services on employment levels is still difficult to distinguish, current trends indicate that the role played by service industries will be much more significant in the years to come.

Location of jobs

One school of thought holds that growth in the service sector offers some hope for reducing regional disparities. Compared with manufacturing or resource-based activities, services, by their very nature, are perceived as more "footloose." Thus they should be easier to locate outside central regions and large areas. In addition, telecommunications should further release services from locational constraints. So much for the theory.

Council researchers have documented that "dynamic" services instead follow a definite development pattern: they tend to congregate in large cities, the larger the urban centre, the higher the concentration index of services.

These services tend to congregate in large cities because, among other reasons, there they enjoy ready access to highly skilled labour, to complementary activities, and to a market composed of other businesses in the goods and service sectors.

In fact, both dynamic-service firms and the head or divisional offices of major corporations tend to locate in large cities. Both are highly dependent upon access to information and face-to-face contact. On the other hand, branch plants, which are geographically more dispersed, have less need for producer services, since those services are, for the most part, provided by their head offices; accordingly, branch plants create less demand for local service plants.

The result of this situation is that disparities within regions – between the largest cities and the smaller urban areas – appear to be increasing. And inter-regional disparities are becoming more pronounced because the major cities are disproportionately located in developed regions.

Services and economic growth

The Council Statement emphasizes that the shift to services has profound implications for economic development. The Council therefore suggests general directions for economic development policies in light of recent changes.

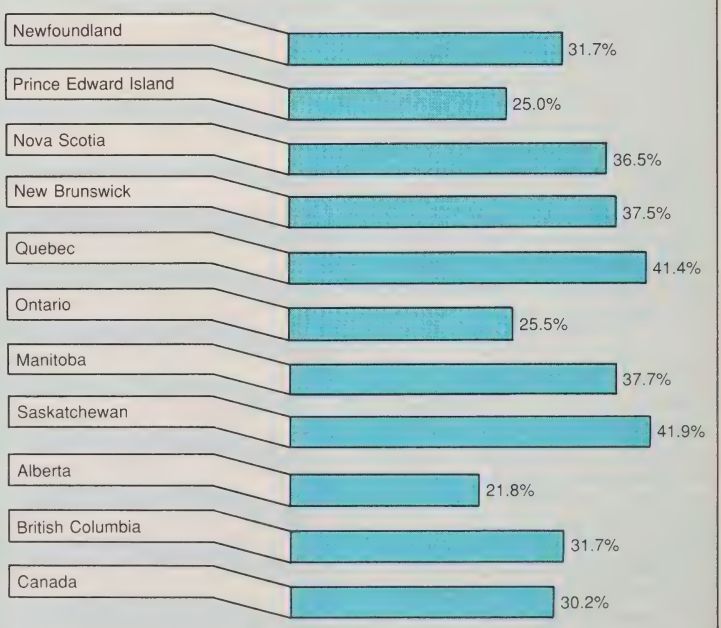
Among other things, government policy should be neutral in its treatment of goods and services, so as to eliminate the traditional bias in favour of resource-based and manufacturing industries.

Industrial policy should be aimed at fostering linkages between the goods and service industries, which already share a number of common characteristics in terms of client-supplier relations.

The key elements of service-sector infrastructure – telecommunications and computer technology – must be recognized by governments as critical components of an information-based economy that are capable of meeting the challenges of international competition.

Finally, the Council recommends that regional-development efforts should be aimed at promoting urban development, building on the complementarities that exist between services and the regional industrial base, developing a highly skilled labour force, and strengthening telecommunications and computer infrastructure.

Contribution of Part-Time Employment to Total Employment Growth, by Province, 1975-88



Education and training: A priority

Government spending on education in Canada rivals that of any other nation. As a percentage of gross domestic product, Canada's public expenditures on education place it in second spot among the industrialized countries.

The Council's analysis of the employment situation suggest however that Canada is not getting a good economic return on its investment in education.

It points to the following deficiencies:

- close to one fifth of the adult population is functionally illiterate (reading at or below a Grade 9 level);
- a relatively high secondary-school drop-out rate (nearly 30 per cent), coupled with a scarcity of apprenticeship and training programs. In the United States, only 13 per cent of 17-year-olds fall outside the formal education and training system; Japan's figure is only 6 per cent;
- Canada's high rate of postsecondary attendance may be due, according to some studies, to its relatively less demanding secondary curriculum;
- Canadian students have failed to rank above the middle level in mathematics and science tests in comparison with their counterparts in some countries;
- a disturbingly high proportion of those taking trade and vocational programs do not appear to benefit from their education; graduates experience high unemployment rates and low average earnings, and the majority report that they do not use the skills acquired in their studies; and
- finally, the relative quality of the high-skill segment of the Canadian work force is judged mediocre according to some international standards. The 1989 World Competitiveness Scoreboard ranked Canada, at best, in the middle group with respect to managerial talent, R&D personnel, and skilled labour.

Unfortunately, the research indicates that the consequence of these deficiencies are heightened in a service economy.

Jobs with high-skill and educational requirements clearly represent a growing share of the labour market. Education and human-resource development have become more critical than ever before at a time when the economy is being constantly buffeted and driven by such forces as technological change, the information revolution, and intensifying global competition.

Countries with high production costs, such as Canada, will have no other choice but to rely on the excellence of their work force to retain a comparative advantage in the global marketplace. A growing number of jobs are information-based. Even those that do not have a high-skill content demand basic literacy and numeracy.

In short, unskilled and poorly educated workers are disadvantaged on the labour market and are facing special problems in adjusting to the changing employment structure.

Education

Considering the fundamental imperatives of labour market preparation – particularly the need to provide Canadian workers with the analytical tools to "navigate" in an information-based society and to foster a standard of excellence through highly educated workers – the Council has concerns about the quality of education in Canada.

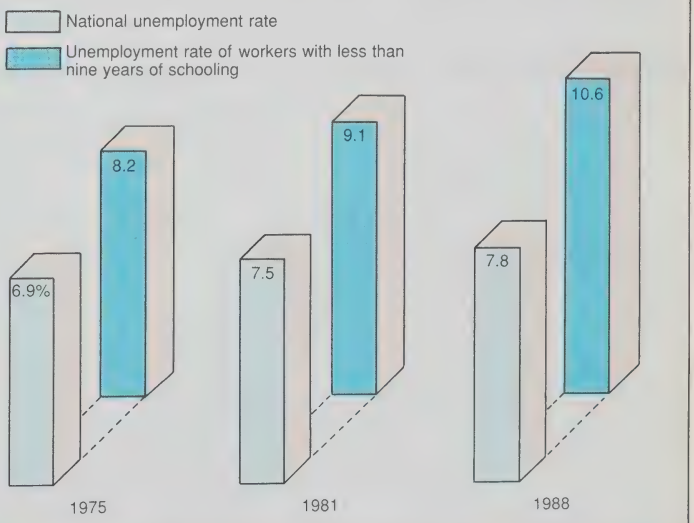
The troubling indicators mentioned above do not seem to be the result of inadequate spending. Although real expenditure per student at the postsecondary level has declined over the past decade, spending on primary and secondary students has been rising steadily.

The Council perceives a growing public awareness of the problems in education, as well as mounting calls for action to solve them.

The Prime Minister recently proposed that a working group be created to determine how Canada's education systems might more effectively meet the country's human-resource needs.

At the present time, the Council does not have full information on the scope of this initiative nor on the response of the provinces. But it stresses that what is needed in this area is hard and well-focused research. It believes that a major empirical study should be undertaken into the state of education in Canada, with a view to pinpointing concerns about educational quality.

Level of Schooling and Rate of Unemployment, 1975-88



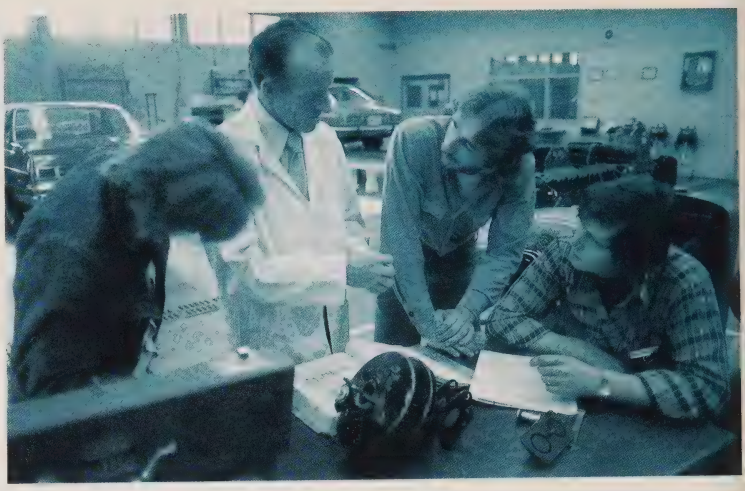
Training and labour adjustment

While high-quality education represents the essential precondition for a first-class work force, the development of vocational skills must be based in the training system. Indeed, training is essential for enhancing on-the-job performance and industrial competitiveness.

The Council's view is that the current training effort in this country is not satisfactory. It is beset by two major problems. First, the investment in education by Canadian industry is insufficient, and the situation is all the more regrettable in light of evidence that employment-based training is the most effective. Second, public policy continues to have a "damage control" orientation, emphasizing income maintenance and short-term training for the long-term unemployed.

The Council considers that, among other things, it will become more important in the 1990s for public policy to deal directly with "unattached" workers. Certain groups – older workers, workers with low educational attainment, and people who have been laid off – have an especially difficult time adjusting to changes in the labour market. And this problem is growing in scope, particularly as the pace of retraining accelerates to meet the changing industrial and professional structure. In 1986, over 40 per cent of those separating from goods-industry employment found their next job in services.

There are also wide disparities in the efficiency with which workers find new jobs.



Training – one of the keys to better jobs.

Policy changes

The Council maintains that policy changes are necessary. It recommends that the share of unemployment insurance (UI) funds allocated to retraining be increased and that the eligibility restrictions for training be relaxed.

As a long-run goal, the Council endorses the transformation of the UI fund into an "employment insurance" fund so as to offer unemployed workers a range of benefit options, including income support, retraining, mobility, and occupational counselling.

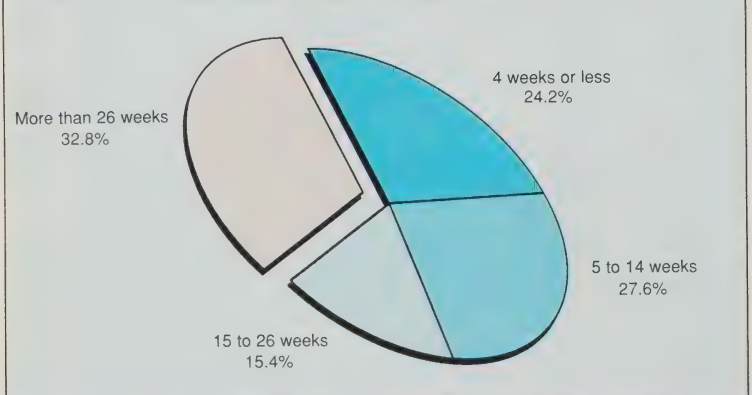
For older workers, policy should be aimed more at reintegration through retraining and counselling than at support payments.

In order to help laid-off workers adjust more easily, the Council urges that labour standards be strengthened by stipulating longer advance notice of layoffs and compulsory labour/management adjustment committees in the event of major layoffs.

The Council stresses the importance of human-resource development by Canadian industry, arguing that training decisions should be decentralized. It also recommends that increased funds be allocated to the Industrial Adjustment Service to help develop sector-specific human-resource plans in industries that have chosen to initiate such plans.

Overall, concludes the Council, Canadian employers, workers, and labour unions need to make a much stronger commitment to training.

Distribution of Job Separators by the Number of Weeks of Joblessness, 1986



"Structural" unemployment

The mere existence of a job opening does not necessarily mean that a jobless worker will find employment.

The process of matching people and jobs involves reconciling a set of infinitely diverse characteristics. The age, sex, education, location, and aspirations of workers must be matched with such job features as pay, working conditions, and skill requirements.

Two working papers – "Unemployment in Canada" and "The Natural Rate of Unemployment" – written by Andrew Burns, an economist at the Economic Council of Canada, trace the evolution of unemployment both nationally and regionally, and come to the conclusion that current high unemployment rates are due primarily to a variety of "structural" factors connected with the labour market. The effect of these factors is to create a widening divergence between the requirements of job vacancies and workers' job characteristics.

Much of the recent rise of unemployment is attributable to the forces unleashed by the 1981-82 recession and the associated drop in commodity prices which provoked increases in mismatch. Over this period, long-term unemployment (lasting more than a year) rose dramatically.

The fact that workers must spend such a long time looking for a job is indicative of a serious mismatch between what employers are looking for and what job seekers have to offer.

While noting that long-term unemployment receded slightly in 1987, Burns stresses the sensitivity of labour markets to external shocks.

Maintaining steady growth in employment is clearly essential to making further progress in reducing unemployment rates. But in order to attack the mismatching problem at its roots, Canada will have to focus on programs and policies that are geared to helping workers move from one kind of industry and/or occupation to another. Thus these policies must be attuned to the needs of the region, or even the community.

Labour market programs that are designed and delivered without taking regional differences into account will prove much less effective in meeting these aims.

Regional structure

Burns notes, first of all, that regional labour markets are distinct and respond to external stimuli in different ways. What would pass for full employment in Ontario, for instance, would mean something else entirely in Newfoundland.

In the second part of his study, Burns traces the evolution of unemployment from a regional perspective. He points out that, generally speaking, long-term unemployment is more evident in those regions that have experienced the most extensive industrial restructuring.

The widening disparities between regional unemployment rates are due, in large measure, to the fact that provinces do not all have the same ability to absorb and adapt to external economic shocks. The timing and pace of the shift in employment to services has also varied from one province to another.

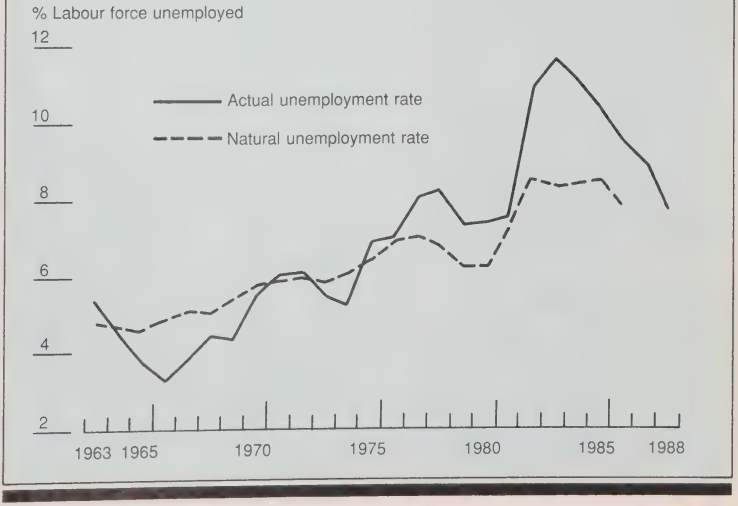
The Prairie provinces and British Columbia experienced the largest relative increase in structural unemployment. In the Prairie provinces, falling commodity prices led to a decrease in construction activity and a general decline in manufacturing.

Ontario experienced very little increase in structural unemployment, owing to the diversity and density of its economy, which enabled workers to move relatively easily from declining to expanding industries. In Quebec, the share of manufacturing in total employment fell less abruptly than in British Columbia, but that decline was not any smaller in overall magnitude. Like British Columbia, Quebec has achieved significant improvements in productivity in the wake of industrial reorganization. That reorganization, however, has brought with it concomitant increases in structural unemployment. Despite a significant absolute increase in unemployment in the Atlantic provinces, industrial restructuring has been much slower. Relative to their initial levels, neither productivity nor structural unemployment increased as dramatically in these provinces.

The author argues that economic policy designed to enhance labour market flexibility would provide the Atlantic provinces with their most valuable weapon in the fight against unemployment.

In general, the author concludes, training programs should aim at producing workers who are able to adapt to rapidly changing economic conditions and who can meet the particular requirements of different labour markets.

Actual and Natural Rates of Unemployment



The economic role of women

The Chairman of the Economic Council of Canada, Judith Maxwell, recently gave a seminar at Statistics Canada to mark International Women's Day. Summarized below is her talk tracing the changing role of women in the economy.

By investing more in the training and education of women and by making it easier for women to successfully balance their work lives with their family responsibilities, Canada would improve its chances of meeting the economic and social challenges of the decades ahead.

Women's contribution will become all the more important in the future because of the progressive aging of Canada's population. By the year 2020, the proportion of workers in relation to the total population will be shrinking. Who will be the caregivers delivering health and social services to the older population? And who will produce the goods and services in a society where workers will be increasingly in the minority?

According to Mrs. Maxwell, women's potential has yet to be fully utilized. "Once we invest more in the education and training of women," she states, "they will be able to enter better jobs and to make an even bigger contribution to society."

That, in fact, may be the key to our capacity both to generate the kind of living standards and lifestyles that Canadians want, and to meet the challenge of an aging population in the coming decades.

According to Mrs. Maxwell, women must also learn to invest more in their own education. Because of family breakups, women are increasingly being called upon to be family breadwinners. Thus it is essential that they acquire the tools they need to improve their situation.

A stabilizing effect on family incomes

One thing is certain about the changing economic role of women: they now make a significant contribution to family incomes. In many cases their financial support is crucial. Mrs. Maxwell argues that it is important to recognize the economic contribution women are making and the stabilizing effect their earnings have had on family incomes.

These developments, in turn, have had an impact on family lifestyles, as women are often forced to adapt to shift work, part-time work, and so on.

In 1911, only 15 per cent of women were in the labour force. Today, more than 60 per cent of women hold a job, with the biggest increase occurring since the 1960s. Only one third of women in the 25-64 age group worked outside the home in 1966. By 1988, the corresponding figure had jumped to 75 per cent and the pace of change continues. By 1986, the typical married woman provided 27.6 per cent of the family income, up from 21.4 per cent in 1973. But female earnings are still only 59 per cent of men's – partly because women are overrepresented in jobs that pay lower wages.

In the past 20 years, there has been evidence of increasing employment polarization for both men and women.

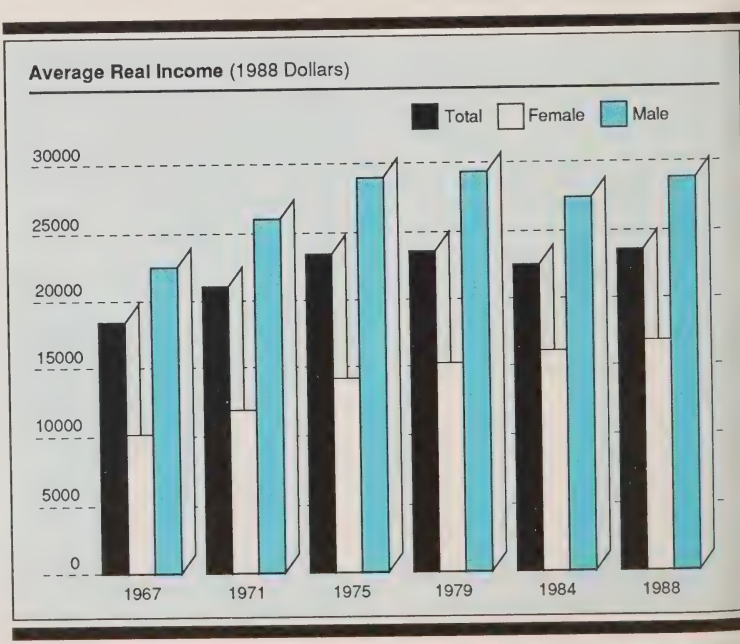
More women are rising to senior positions that are well paid, yet most must still devote a significant portion of their time to their children's education, their parents, and the smooth running of the household.

According to Mrs. Maxwell, however, a large proportion of women are found at the other end of the spectrum – in bad jobs with a high degree of instability. Suffering from a relative disadvantage in training and education, and frequently saddled with heavy family responsibilities, these women find themselves trapped in poorly paying dead-end jobs that in many cases leave them stranded in poverty.

Some women accept jobs of this kind because of the inherent flexibility. They sacrifice career development in order to fulfil their nurturing roles.

Others take on part-time work simply because they cannot find anything else. Still others are disadvantaged because of discrimination – the principle of equal pay for work of equal value is not respected.

Overall, says Mrs. Maxwell, "the picture that emerges is one of underutilization." These women are experiencing hardship and are not achieving their full potential. And it is society as a whole that is the poorer.



Education and training

Not only are Canadian employers under-investing in employee training, but such training as they do provide tends to be heavily concentrated among highly skilled, well-educated male workers.

However, women have made spectacular improvements in their commitment to higher education. No less than 53 per cent of all Bachelor's degrees are now granted to women – up from a 38-per-cent increase in 1971. There are also important changes occurring at the Master's and Ph.D. levels.

"There are overall signs that the educational attainment of young women entering the work force these days is higher and more diversified," notes Mrs. Maxwell.

An excessive burden

Mrs. Maxwell finds it troubling that society sometimes places an excessive burden on the shoulders of women. "I have seen too many cases of women in their 40s and 50s who are quite simply worn out," she says.



Women's earnings have helped stabilize family incomes.

Employment and Immigration

Participation Rates of Males and Females, by Age Group, 1966 and 1989



These are people who have worked for 20 years or more, who have earned the respect of their colleagues while they have raised a family. They are often divorced or bereaved or have had to take on more than their fair share of family-related responsibilities.

The result? A woman in this situation may suddenly find it necessary to take an extended period of leave. There is no specific illness; she is simply worn out and depressed. "I agree she needs rest," stresses Mrs. Maxwell. "But I sense that what she needs more than anything is a little bit of hope and peace of mind."

Not only are sad cases such as these costly to employers, they also represent a terrible waste of resources.

And it is precisely in order to avoid that kind of waste that society must invest more in women.

So, concludes Mrs. Maxwell, the more encouragement we give to women by offering them better training, better support systems (including child care and elder care), and more flexible working arrangements, the better their chances of achieving their true potential.

Mergers and acquisitions

In recent years, the media have reported on many spectacular corporate takeovers in Canada, the United States, and Europe.

Ever since the beginning of the twentieth century, mergers and takeovers have tended to wax and wane in a cyclical fashion. We are now apparently in the throes of another such cycle, one which experts consider to be of unprecedented intensity. Because these "marriages" (of convenience, or otherwise) have such potentially important effects on the economy, interest in the phenomenon on the part of businessmen, workers, and ordinary Canadians, to say nothing of governments, is very high.

Some experts regard mergers and takeovers as a good way to rationalize administration and production; others worry about the ultimate implications of allowing control of the economy to fall into the hands of a small number of megacorporations.

Corporate mergers and takeovers, then, have emerged as a major issue of the day. To throw more light on this subject, the Economic Council of Canada recently began a pilot research project.

Au Courant recently interviewed the leader of this pilot project, Senior Economist, Abe Tarasofsky.

Au Courant: *What were the reasons for the Council deciding to undertake this research project on mergers and acquisitions?*

Tarasofsky: For some time, the Council has been interested in the question of what kind of firms would be likely to be competitive in the emerging global economy. A number of leading business spokesmen have been arguing that what Canada needs is more big corporations. By implication, they mean firms that became big by acquiring other firms. That is one basic reason. Another basic reason is the observable fact that in Canada, and even more so in the United States, the United Kingdom, and Western Europe, there has been a tremendously strong trend during recent years for firms to acquire other companies. So the subject of corporate acquisitions has been very much on people's minds. Some theorists have argued that these acquisitions are basically very healthy things, while others have argued the opposite.

Au Courant: *What are you trying to find in your study?*

Tarasofsky: My study is a pilot study and is best understood as part of a wider exercise. The specific question with which I am concerned at the moment is whether corporate acquisitions are profitable. Do acquired firms become more profitable after being taken over, or less? The existing evidence is extremely mixed. There is relatively little Canadian research on this subject, which is why we thought it would be useful if we did some.

Au Courant: *Is this a recent phenomenon?*

Tarasofsky: Corporate takeovers are anything but a recent phenomenon. They go back to the emergence of corporations as important business organizations. The phenomenon is a very cyclical one and has been tracked since the beginning of the twentieth century. Canadian cycles appear to coincide very closely with American cycles.

Au Courant: *Why should a firm choose to expand by acquiring another firm?*

Tarasofsky: There are many possible reasons. For instance, there are solid economic reasons, such as potential efficiencies of scale and of scope, and potential administrative efficiencies, depending on the relationship between the two firms. Or, there might be purely speculative reasons having to do with the way stock markets work. Finally, there might be managerial reasons reflecting the diversity of interests between managers of corporations and shareholders.



Abe Tarasofsky

Au Courant: *Are there dangers if the economy becomes dominated by a small number of megacorporations?*

Tarasofsky: That is a very important question in Canada because approximately a dozen large conglomerates represent about 20 per cent of the entire Canadian corporate sector. Ten years ago they represented about 10 per cent.

> ***"Canada has had all along, and continues to have, one of the most highly concentrated economies in the world."***

Canada is the only country in the western world where conglomerates are so important, and it is unfortunate that we know so little about them. The American experience makes the subject especially interesting. While their

conglomerates performed extremely profitably from the early 1960s to the mid-1970s, they have been performing poorly since, divesting many of their acquisitions. This is striking because, during roughly the same period, Canadian conglomerates doubled their share of the economy.

Au Courant: *Are there specific government regulations in regards to mergers and acquisitions?*

Tarasofsky: Canadian competition law has always allowed the government to scrutinize mergers and prohibit those that restricted competition. When the current Competition Act was introduced three years ago, it explicitly recognized that certain mergers, even though they potentially restricted competition, could be justified on grounds that they increased efficiency.

Au Courant: *Do mergers or acquisitions have any bearing on the work force?*

Tarasofsky: This question is not an aspect of the present pilot study, but we hope to be able to look into it in the near future. We have a certain amount of American evidence on this question and it is quite mixed.

Au Courant: *Do takeovers tend to transfer resources into more productive hands?*

Tarasofsky: On the whole, the profitability of the acquired assets remains about the same as it was before. Generally speaking, from the standpoint of profitability, resources do not move into more productive hands. I have found that about four acquired firms out of 10 improved their performance. An equal four out of 10 recorded deteriorated performances, and the other two remained where they were before. There are, however, other important considerations that should be explored, such as the effects of acquisitions on wages and jobs, as well as on suppliers and lenders. We have not yet been able to investigate these issues but we are hoping to do so. We also hope to examine whether Canadian tax rules, such as interest deductibility and loss provisions, have had a perverse effect by prompting takeovers that otherwise would not be economically advisable.

> ***"Some theorists have argued that these acquisitions are basically very healthy things, while others have argued the opposite."***

Au Courant: *Could this phenomenon affect Canada's performance in the world market?*

Tarasofsky: In order to investigate that question, you first have to study the relationship between acquisitions and corporate concentration. Canada has had, and continues to have, one of the most highly concentrated economies in the world. Next, you need to investigate the effects of high concentration levels on the economy, if they have produced more efficient or less-efficient firms, and whether they have had adverse equity effects. Because of the free-trade agreement and the rapidly increasing globalization of markets throughout the world, it is a question that is becoming ever more important because it is not clear how increased foreign competition will affect the performance of firms in highly concentrated industries. We hope to shed some light on these issues.

> ***"Canada is the only country in the western world where conglomerates are so important, and it is unfortunate that we know so little about them."***

Au Courant: *What are your tools for measuring profitability when a merger or acquisition has taken place?*

Tarasofsky: Two kinds of data have traditionally been examined to investigate the profitability of acquisitions: stock market data and accounting data. One of the advantages of our present research is that we are using both. We hope thereby to provide a more comprehensive answer to that question.

Au Courant: *Can you draw any conclusion from your preliminary work?*

Tarasofsky: The most important conclusion that we can draw so far is a negative one, namely that takeovers are not, in general, an especially efficient way for firms to grow.

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PUBLICATIONS

Council Report

Good Jobs, Bad Jobs (EC22-164/1990E; $5.95 in Canada; US$7.15 outside Canada).

Good Jobs, Bad Jobs draws a new portrait of the Canadian labour market. This Statement by the Economic Council of Canada focuses on the shifting structure of this country's economy, from one based on resources and manufacturing to one where most people are now involved in the production of services. The report concludes that fundamental changes are occurring in the labour market and that many of Canada's institutions and patterns of behaviour must be reshaped to build a first-class work force and to enhance the security of workers in the future. To this end, it considers a range of policy issues regarding training and labour-adjustment, employment-benefit standards, and industrial and regional development.

Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than to the Council.

Adjustment to International Competition: Short-Run Relations of Prices, Trade Flows, and Inputs in Canadian Manufacturing Industries, by Richard E. Caves (EC22-165/1990E, $6.50 in Canada; US$7.80 outside Canada).

The author analyses, for the first time, the responses of Canadian manufacturing industries to changes in international competition – changes in prices and varieties of imports, in Canadian tariffs, and the exchange rate. He concludes that Canadian manufacturing industries are fairly dynamic; when faced with toughened competition from abroad, they meet the challenge by increasing investment, raising labour productivity, changing their product lines, and altering the markets to which their products are sold. This research study contributed to an Economic Council of Canada policy statement on the impact of the Canada-U.S. Free-Trade Agreement.

Working papers

No. 1 "Unemployment in Canada; Frictional, Structural, and Cyclical Aspects," by *Andrew Burns.*

No. 2 "The Natural Rate of Unemployment; A Regionally Disaggregated Approach," by *Andrew Burns.*

Discussion papers

"Recent Proposals to Reform the Bankruptcy Act: An assessment," by *Benoît M. Papillon.*

Correction

In the last issue of *Au Courant* (Vol. 10, No. 3), the alert reader will no doubt have noticed a problem with the chart on page 9 diagramming the market shares of Pacific Rim countries. As a result of an error in paste-up, the legends for the columns were shifted. The first column on the left actually represents the *total* percentage of exports, and the following columns the respective market shares of Japan, the Asian NICs, the ASEAN countries, and China, in that order.

How to order

Research studies and Council reports are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion papers, working papers, and the *Annual Report* are available without charge from the Publications Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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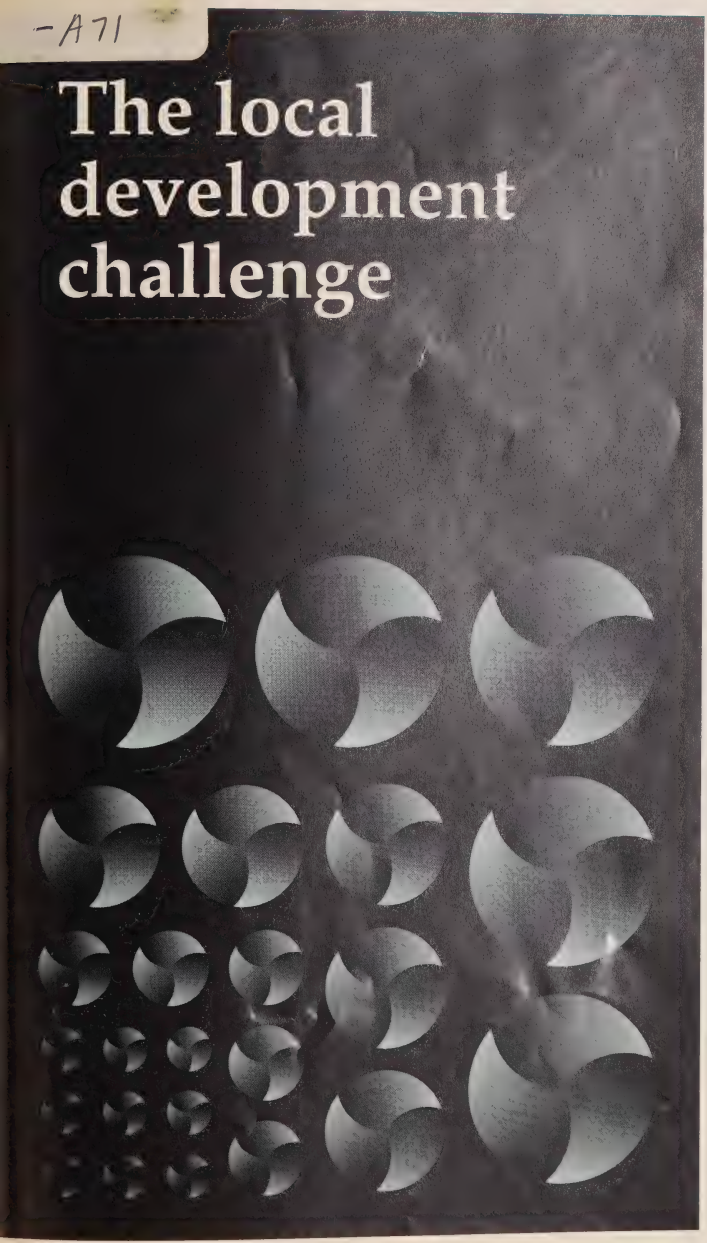
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The local development challenge

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Au Courant *est également disponible en français.*

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its staff and others. The findings of these reports are the personal responsibility of the authors.

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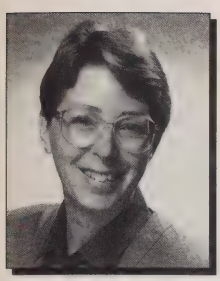
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Editor: Jean-Guy Bruneau

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Judith Maxwell

Think globally, act locally

"Think globally, act locally," one of the mottos of environmentalists, is an apt caption for the Council's two main publications this spring.

The proceedings of the Perspective 2000 Conference highlight the evolving nature of the global economy. A multipolar world economy is replacing the one where the United States dominated, for example. And the growing complexity of the links between technology, environment, and population means that events in one community can spill over into neighbouring countries or regions. At the same time, these physical linkages could cause discontinuities – abrupt changes in technology or in ecology can produce unexpected reactions which are irreversible.

The Conference (convened to celebrate the 25th Anniversary of the Economic Council of Canada) identified these global forces and then explored their repercussions for Canada, with special emphasis on industrial relations, education, social security, and decision-making institutions.

There is no question that Canadians are exposed to greater pressure due to global competition. Canadians are also in a position to explore new opportunities for trade and investment, and for burden-sharing across nations.

Such remarkable changes on the global scene quite naturally provoke local action. One example is the way in which the Canadian business community is beginning to think globally in its international trade. We are becoming more and more integrated into the world economy – the volume of exports as a proportion of total production in Canada has increased from 27 per cent in 1981 to 33 per cent in 1989, a truly remarkable increase.

As global markets integrate, however, there is clearly a risk that some of the less-developed regions of the country will simply be passed by. It is difficult, for example, for a province like Newfoundland to attract a major manufacturing facility, when it may be competing with skilled but inexpensive workers in countries like Malaysia or Ireland.

Economic development in Canada is very uneven. There are wide expanses of hinterland sprinkled with single-industry towns, large sections of provinces dependent on a single resource base such as the fishery or grain farming. Even many larger cities include pockets of economic stagnation.

For years, economic development policies in Canada have been dominated by three themes:

– building roads and other physical infrastructure, frequently to encourage development of natural resources;
– creating incentives for the transplant of major manufacturing facilities into declining regions; and
– maintaining incomes by transfers to provinces or to individuals.

In its Statement, *From the Bottom Up*, the Council has identified a fourth theme. This theme emerges from an examination of the economic development experience in a variety of communities from Nanaimo in B.C. to the Great Northern Peninsula in Newfoundland. The common thread among these experiences is that local action can work. But it is essential to build a new kind of infrastructure, composed of leadership, management skills, and information networks.

Once that new kind of intangible infrastructure is in place, new energy is released. As the community develops the capacity to use the plethora of information about potential markets and useful technologies, it becomes possible to visualize the economic potential of the community.

Gradually, these communities can show a capacity to create a new dynamic, forming new firms, building new confidence and, most important, creating new job opportunities for the local labour force.

These community development efforts are fragile. They depend on good luck as well as good economic and business skills, but they offer a hopeful avenue for development to many of Canada's smaller communities that could easily go unnoticed in the blur of global trends.

A promising approach

As we look at regional disparities at the end of the 1980s, the problems do not appear much different from what they were in the 1960s, when the Canadian government first introduced policies designed specifically to reduce economic disparity between the provinces and regions of the country.

Today, the economic decline of small communities, particularly those in "disadvantaged" provinces and "remote" regions, is still a problem in virtually every part of Canada (indeed, it is a problem common to all industrialized countries).

The residents of small isolated communities wrestling with difficult economic conditions face some no less difficult choices if they hope to improve their lot. They can remain in a situation of chronic dependence, they can emigrate, or they can choose the path of development, with all its demands and challenges.

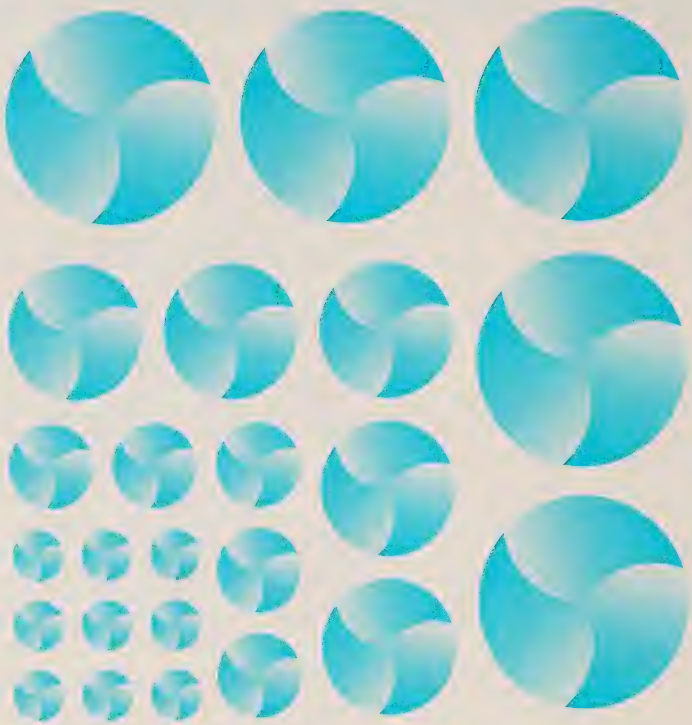
This last alternative is investigated by the Economic Council of Canada in its most recent Statement, which takes a close look at the relatively new approach known as "local development."

Entitled *From the Bottom Up: The Community Economic-Development Approach*, the Statement focuses on the new approach that has appeared in recent years whereby local development organizations (LDOs) act as the primary instruments of economic development.

This approach marks a sharp break with the past, since for more than 25 years development initiatives were centralized and administered by the federal or provincial governments. Unfortunately, such "top-down" programs, directed by higher government authorities, have not had the hoped-for results.

More recently, there has been some interesting "bottom-up" initiatives, i.e., efforts launched by isolated communities themselves, and these have suggested that the earlier remote-controlled, bureaucracy-driven programs are not the most effective and efficient option.

As a first step in its research, the Council commissioned 14 case studies of locally based development initiatives in various isolated areas of Canada. (Most of these studies were published as part of the "Local Development" series and are available from the Publications Division of the Economic Council of Canada.)



From the Bottom Up

The Council then tried to answer such questions as the following: What can be reasonably expected from community-based initiatives? What kind of support do they need from the federal and provincial governments?

In short, the Council wanted to find out how such new factors as entrepreneurship and community development could help solve the problem of economic stagnation in certain regions.

The current situation

Despite governments' best efforts, gaps in development opportunities, particularly in more remote regions, have not only persisted but, in many cases, have widened.

Key industries in the primary, secondary, and services sectors are already on the decline or are facing the prospect of plant closures.

A simple comparison of per-capita income in terms of gross provincial product shows dramatic differences between regions. In Atlantic Canada – the most glaring example – per-capita income in the late 1980s was barely 80 per cent of the Canadian average.

Unemployment rates in the Prairies, which had been consistently lower than those in Ontario for nearly 30 years, are now much higher. With the exception of 1981, the gap between the rates for British Columbia and Ontario has persisted.

Pockets of very high unemployment tend to concentrate in regions that are dependent on fishing, farming, mining, and forestry. Most of these depressed areas have been fighting a losing battle to maintain their economies in the face of declining relative commodity prices.

In short, Canada's unemployment problem is, at least to some extent,

centred in smaller and more remote communities whose resource base is depleted or diminished by weak prices.

The Council notes, however, that such cases of underdevelopment do not necessarily indicate the absence of development potential in the communities concerned, but rather a need for new mechanisms. The reason that many local economies are not performing well may be that their human and physical resources are not being fully exploited.

If they are to survive and offer employment opportunities for their citizens, these communities need to mobilize new resources and diversify their economic base.

"... such cases of underdevelopment do not necessarily indicate the absence of development potential in the communities concerned but a need for new mechanisms."

The new approach – local development

While recognizing that the concept of local development as a tool for economic development is still experimental, the Council believes that this approach can revitalize the economies of small and isolated communities.

The Council feels that communities can take their own development in hand through local development initiatives aimed at fostering entrepreneurship and increasing the community's ability to respond to market opportunities.

One caveat: this development strategy cannot be a panacea for the problems of *every* community faced with economic adversity.

One aspect that is a subject of considerable debate among development experts is financing – how much and how to allocate it.

The Council stresses that communities must commit their own resources to the process and, in order to maintain local control, must not rely exclusively on public-sector funding. Community support for local development initiatives also serves to enhance their credibility. Community commitment, says the Council, should even become a prerequisite for government support.

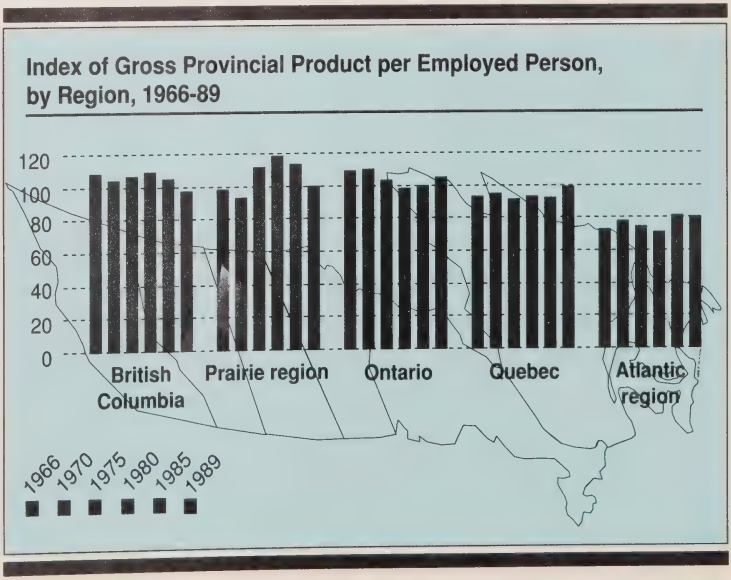
At the same time, public-sector assistance must be applied in ways that do not stifle the enthusiasm and innovativeness of local development organizations and do not interfere with the local control that is the essence of the community-based approach to economic development. In other words, arrangements should be as flexible and unbureaucratic as possible.

Yet many communities simply do not have the skills needed to launch bottom-up initiatives. Thus development efforts must concentrate on capacity-building.

It is not infrastructure in the traditional, physical sense – water and sewer systems, highways and wharfs – that the Council is referring to here, but the critical need for small communities to have access to as complete information as possible on development possibilities and potential. Thus the Council calls for the creation of local information infrastructures to allow communities to capitalize on market opportunities and to foster entrepreneurship in a wide range of projects.

The Council's studies suggest, in short, that community-based economic development action can, in the right circumstances, be an effective approach. It can improve labour resources; it can be instrumental in introducing new technology; and it can make the community more responsive to external market opportunities.

And, as demonstrated by the Canadian experience, local development organizations can indeed operate commercial enterprises effectively.



The constraints of development

In deciding which communities should receive assistance, there are two criteria: the degree of need and the potential of the community concerned.

These criteria automatically exclude two categories of communities: those which are flourishing and do not need assistance; and those in which, with or without assistance, there are no prospects for improvement.

While measuring need is relatively simple, assessing development potential is much more complex.

In fact, there are no generally accepted methods for determining the prospects for growth in a given geographic area.

That is why the Council believes that communities should become involved early in the development process, in fact, at the selection phase itself. The initial estimation of development potential should come from the community and its local development organization (LDO) rather than from the funding agency.

Five handicaps

Before economic development can begin, however, the groundwork has to be laid. In this regard, states the Council, it must be recognized that smaller communities suffer from five important handicaps that must be addressed before these communities can realize their full economic potential.

And, as the Council's survey of various Canadian initiatives has shown, all five of these difficulties are more amenable to local-community remedies than to correction orchestrated from afar.

These five handicaps are as follows:

– very high unemployment: In some cases, half of the working-age population is out of work. This is both a consequence of underdevelopment and an obstacle to the community's future economic growth. High unemployment erodes skills and entrepreneurial vigour, provokes migration of younger, better-educated people, and may lead to decay in social amenities. All of these factors make the community a less attractive place for business.

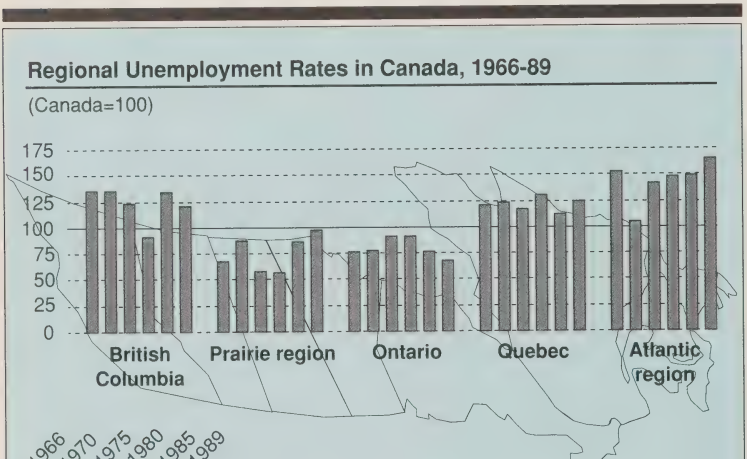
– shortage of information: This is a major handicap for smaller communities. Information is the most basic building block of modern economic development. The larger urban centres, for example, possess financial institutions, market research organizations, colleges, universities, and so on. An LDO, however, can create to some extent the small-town counterpart of the internal information networks that serve urban businesses.

– lack of basic social services: Many smaller communities do not enjoy the same basic social services (health care, housing, education and training) that most large urban centres take for granted.

– inadequate access to capital: This is the typical chicken-and-egg syndrome. Potential entrepreneurs in small communities find it difficult to borrow at terms comparable with those available to urban businesses. As a result, entrepreneurs depart for greener pastures and the vicious circle of stagnation is perpetuated.

– cost disadvantages: In small and remote communities, production may suffer in comparison with urban-based production because of locational factors (distance to markets, transportation costs, etc.), lack of economies of scope and scale, and generally higher costs.

These five major handicaps, states the Council, must be addressed at the local level.



The Canadian experience

The Council's study of several locally based economic-development initiatives in Canada shows that they involve a wide range of activities. They can be divided into two broad categories. The first consists of supply-side measures – the steps that communities take to enhance or expand local resources in an effort to improve their capacity for development. The other side of the coin is demand-oriented measures that communities may take in response to market opportunities.

The measures undertaken to achieve local-community development on the supply side involve three basic kinds of activities:

– utilizing idle human and physical resources;

– expanding the community's resource base; and

– increasing the productivity of local resources.

One common goal of local economic-development efforts is to mobilize and more fully utilize human resources. Job creation for unemployed people is usually an objective (at least implicitly), although it is sometimes combined with other goals such as training and worker motivation.

The Council's research uncovered several examples of communities that have turned idle resources to productive use.

LDOs have also expanded the financial resources available to their communities in various ways. Some communities have shown that they can strengthen the local capital base by pooling government funds and local capital. By extending loans to local businesses, the latter are able to tap into different sources of capital that would otherwise be out of reach.

"Some communities have shown that they can strengthen the local capital base by pooling government funds and local capital."

Finally, LDOs can improve the economic productivity of local resources, including human resources, in a variety of ways. This enhances their ability to compete in external markets.

Some communities have set up training and development programs to improve labour productivity. The adoption of better management techniques and newer technology has also been an important source of productivity gains.

It is equally important, says the Council, to examine the role of the LDO on the "demand" side of local economic development – specifically, its role in responding to market forces. When the spur to community-based action is economic hardship, one of the first requirements is usually mobilizing the community to the common cause of revitalization. An important aspect of work in this phase is inculcating realistic expectations in the community about the status quo and the future through analysis and information dissemination.

LDO business ventures

Community organizations that operate business ventures are often referred to as "community-development corporations" (CDCs).

In many respects, a CDC functions like a privately owned business: it plans and implements investment strategies; it manages day-to-day operations; it determines production and employment levels; and it monitors its own productivity.

CDCs usually have two purposes. They provide the community with a lever for implementation of its economic-development strategy, and they earn revenues for the parent LDO and thus make it more financially independent.

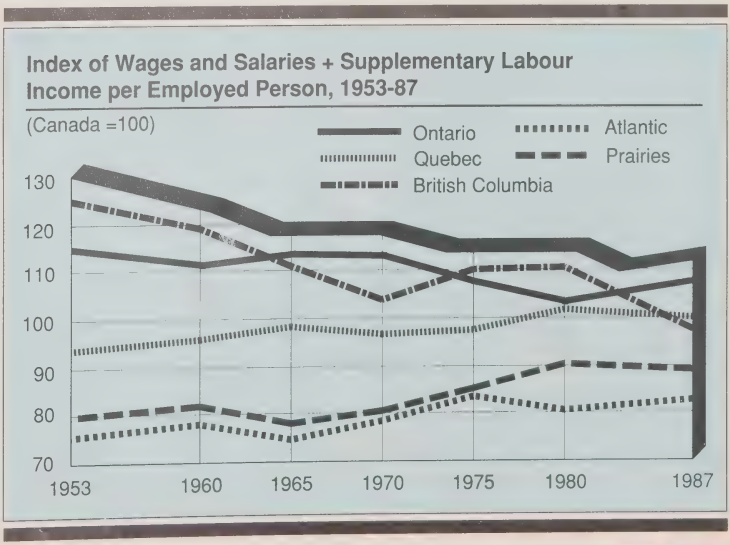
Community groups going into business are as much involved in innovation and risk-taking as private organizations, and they are as much subject to failure. In many cases, though, they enjoy a competitive edge based on their intimate knowledge of the locality and the region.

The track record of CDCs shows that success is more common among those that have chosen to invest in several sectors rather than in only one or two.

The Council nevertheless believes that the direct commercial ventures of LDOs should not be funded through the medium of government programs designed to support local-community economic development, but should draw upon existing business assistance programs.

This position assumes that LDOs are able to access such programs to secure funding for their business ventures. All too often, unfortunately, communities find it difficult to tap into them. It is important to ensure, states the Council, that LDO-based business ventures enjoy the same access to business assistance programs as private enterprise.

The Council points to statistics indicating that LDOs sometimes failed to make use of some programs simply because they did not realize that they were eligible or because they were intimidated by the red tape or the financial eligibility requirements. All too often, their businesses simply did not even bother to apply.



An "information infrastructure"

Local development organizations (LDOs) need to select their targets carefully when drawing up their economic-development plans.

While the Council's studies suggest that community-based action can be an effective formula for certain communities under the right circumstances, it is essential that the objectives established at the outset are the best possible.

As the Council points out in its Statement, LDOs have devoted considerable effort to increase the availability and to lower the costs of the financial capital that their communities need for development. While this approach makes sense in some cases, however, in general the potential effects are limited.

It would be more productive, says the Council, to concentrate on improving the information infrastructure.

Indeed, many local firms fail to find capital because they do not know where the sources are or how to use them. LDOs can overcome this obstacle by providing the necessary information and counselling services.

The range of information that firms can put to productive use – about markets, production, technologies, funding sources, and other matters – is virtually infinite. The challenge is to reach selectively and efficiently into this pool and to extract, sort, and transfer information relevant to the needs of a specific firm in a specific community.

LDOs can meet market information needs either by taking the initiative in supplying information or by responding to specific requests.

The promotion of the community to outside buyers of locally produced goods and services and to potential investors in local businesses is another important focus for local-development efforts. While these promotion activities have traditionally been undertaken by local industrial commissions, LDOs can often do a more effective job.

Consequently, LDOs should give a high priority to building human-resource and information infrastructures. The importance of this aspect of community development, stresses the Council, can hardly be overestimated. This type of infrastructure is as vital to development at the end of the 20th century as railroads were at the end of the last century.

The Council also strongly advises LDOs to respond more actively to market opportunities. Its research shows that some of the most successful local initiatives have been characterized by openness and adaptation towards changes taking place in the marketplace at the local, national, or international level.

A diversified array of projects is another important asset that serves to increase the stability and sustainability of the overall development effort.

LDOs engaged in commercial activities should avoid conflict with the local private sector by looking first for joint-venture opportunities and by concentrating on goods or services that are not being produced in the community. A venture into existing traditional industries (housing, minor repairs, consulting and financial services, and so on) is likely to encounter resentment.

Lastly, it is important to undertake regular evaluations and, as far as possible, to participate in national data-gathering activities. LDOs have every interest in promoting wider knowledge and assessment of their own activities.

Some constraints

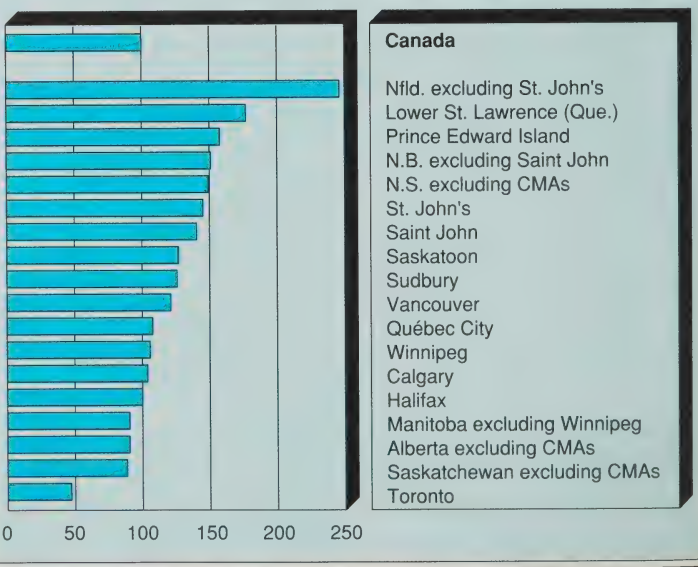
The fact that the dynamic and fast-growing service industries tend to concentrate in larger urban areas adds to the problems of smaller communities. This trend was extensively explored in the Economic Council's recent Statement on the services sector (*Good Jobs, Bad Jobs*). If the pattern continues, smaller and more remote communities will not share significantly in the growth of the dynamic services sector.

The migration of younger workers with the best training and education to large urban centres is tending to deplete the human-resource base of smaller communities.

These are only some of the difficulties with which smaller communities must contend.

Unemployment Index - Selected Regions, 1988

Canada=100



The state and public funding

There are many questions connected with public-sector funding and the role of government in local economic development.

The financing problems encountered by LDOs are likely inherent to all communities wrestling with economic stagnation. In this area, economic development strategies find themselves facing a difficult dilemma. The most obvious solution, of course, is to rely on government funding. However, such a course of action runs the risk of compromising local control – one of the main assets of the local-development approach. This becomes an especially important factor when the development goals of the LDO are not completely consistent with the goals of the government program providing the funds.

The solution, says the Council, is to strive for a reasonable balance between local community control and responsible supervision of spending by the funding agency.

First of all, suggests the Council, the community should make a point of not relying exclusively on public-sector funding. A decision to put local money into local development demonstrates the confidence of the community in the prospects for success. And, at the same time, the community's contribution to the economic development project builds credibility with financial institutions and potential private investors.

The community's contribution need not be limited to funding. It can include a varying mix of its resources, including skilled and unskilled labour, buildings and other inputs.

Another way to minimize dependence on outside public funding is for the community to mobilize funding from within – from municipal governments and the local private sector. Local firms and individuals are likely to support the LDO financially in return for a feeling of ownership and shares in development decision making.

Another potential source of funding is other private-sector groups on the local scene, including labour unions, credit unions, and other representative organizations with a stake in the community's economic viability.

Lastly, recommends the Council, the government funding agency should make it clear at the outset that funding will not continue indefinitely, but will be phased out as the LDO is able to take on greater responsibility. In the early stages of the process, government support can be used to help the community complete some of the planning groundwork, including the assessment of prospects, the building of capacity, and the planning of strategies to achieve development goals.

Eventually the community's financing needs will grow and the nature of its expenditures change. At this stage, the LDO can begin to draw on public-sector funding programs.

In short, the Council recommends that financial and human-resource commitment by the community be a prerequisite for provincial and federal government support for community development.

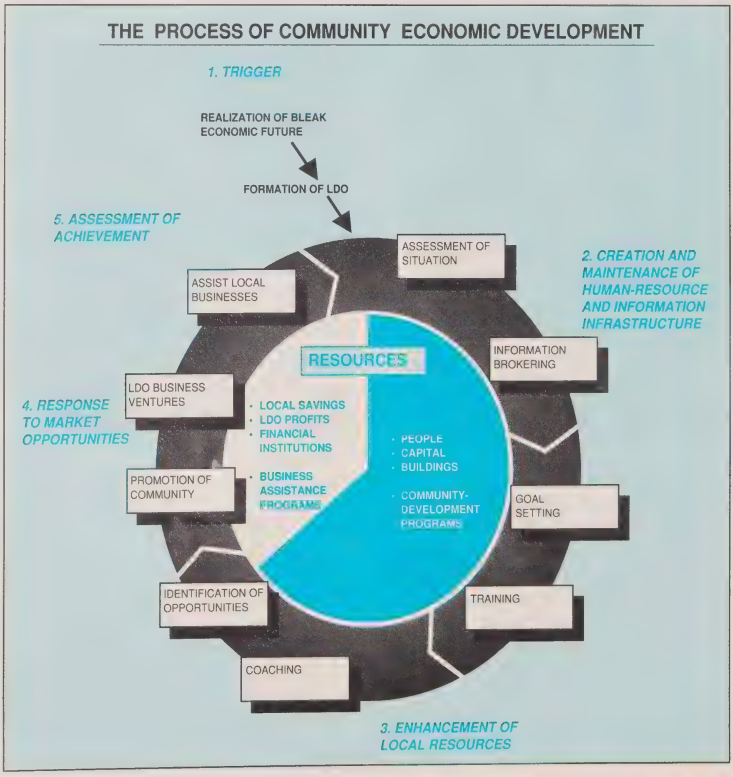
There is some debate among policy-makers about whether or not large urban areas should be eligible for community economic-development programs. While there are underdeveloped areas in many large urban centres, cities are less likely to suffer from the human-resource and information infrastructure gaps that are the designated targets of these programs.

The Council suggests that urban neighbourhoods be considered for support, but that priority be given to the smaller and more remote communities.

Roles of government

The federal and provincial governments have been supporting community-based economic development for several years now.

The Council does not advocate, at least for the time being, any increase in expenditures. Rather, more effective use should be made of the money currently available



by, among other steps, amending the principles and delivery mechanisms of public assistance.

As noted earlier, the focus of government funding assistance should be building up human-resource and information infrastructure.

What is not completely clear is how best to coordinate the efforts of the three levels of government in this area.

Without recommending a specific mechanism for coordination, the Council proposes two broad principles to guide policymakers.

While recognizing that all three levels of government have a role to play in supporting community economic development, the Council suggests that municipal governments should have the most extensive ongoing and direct relationship with LDOs. In fact, the Council believes that the farther removed the concerned level of government is from the local-community level, the less extensive should be its direct involvement in the operation of local-development efforts.

Second, the mechanisms of support should be as free of bureaucratic involvement as possible.

The Council concludes that those communities that display the self-confidence and commitment needed to direct their own development merit public support.

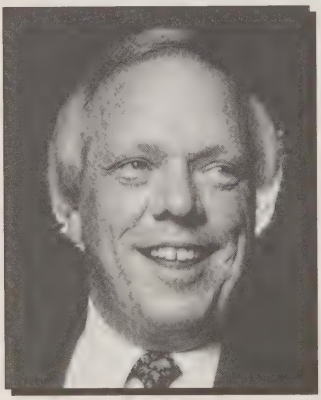
The amounts of money that they need are small and can be found in existing programs.

For the people involved, the potential payoff in human dignity and in the economic vitality of these small communities could be big indeed.

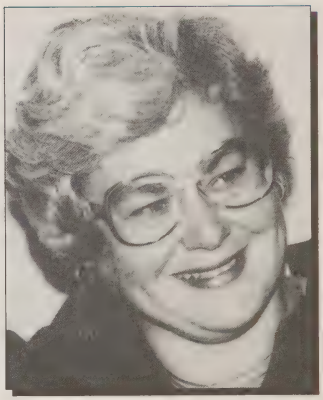
New Council members



Donald J. Savoie is the Executive Director (and founder) of the Canadian Institute for Research on Regional Development. He holds degrees from several prominent universities, including a PhD from Oxford. He has occupied a number of senior positions in government and has frequently served as a consultant to federal and provincial departments. Now a professor at the University of Moncton, he is the author or editor of numerous books and other publications.



Roger Phillips is President and Chief Executive Officer of IPSCO Inc., and also a director of the company. A graduate of McGill University, he has held from 1960 to 1981 numerous senior positions for Alcan Aluminum Ltd, such as Vice-President of Technology, Research and Engineering and President of its subsidiary Alcan International Ltd. He is a director or a member of numerous Canadian organizations. He is Director of Royal Trustco Ltd and senior member of the Conference Board.



Nancy Jackman is President of a numbered Ontario investment corporation and Vice-President of ARC ROTAR Engine Company. A graduate of Whitworth College in Spokane, Washington, and of York University in Toronto, she has been actively involved in a variety of organizations and associations at the local, provincial, national, and international levels. She is a founding mother of LEAF and the Canadian Women's Foundation.

A bold look at the future

On May 31, the Economic Council of Canada published Perspective 2000 – Proceedings of a Conference, *bringing to a conclusion the project of the same name. This project marked a sharp departure from the Council's usual studies and publications, with strikingly different aims and analytical framework. One of the main figures behind this project, Jean-Pierre Voyer, senior economist with the Council, outlines below the main themes and highlights of the project and the ideas it generated for Canada and the rest of the world as we approach the 21st century.*

The Perspective 2000 project, launched as part of the celebrations surrounding the 25th Anniversary of the Council, sought to identify and explore a wide range of public policy issues that may face Canadian decision makers at the turn of the next century. Rather than following the conventional path of carrying out new research and producing new economic forecasts, the Council set out first of all to draw up a list of themes and major issues most likely to be of general interest on the eve of the year 2000. The Council then solicited the views and predictions of experts on these issues from the points of view of their respective fields of expertise. These scholars prepared papers for us with an international perspective, and 12 other specialists were asked to analyze the material from a specifically Canadian viewpoint. The entire group of experts then delivered their ideas and analyses to more than 80 business executives, senior public officials, labour leaders, and other prominent decision makers at the Perspective 2000 Conference held in Ottawa on November 30 and December 1.

The Conference provided a unique opportunity for its participants to reflect on and discuss the many challenges and dilemmas that they will face in the future. One way of describing the event would be to call it an "intellectual feast." Encouraged by the enthusiastic response to the Conference, the Perspective 2000 team undertook to summarize the topics raised at the Conference and to organize a series of regional seminars in order to offer the material presented at the Conference to a wider audience.

What was truly unique about the project, however, was its unusual framework. We targeted three very specific objectives. First of all, we wanted to address long-run public policy issues with a longer-term outlook than is usual for Council research. In this regard, we quickly realized that the more distant the horizon, the greater the possibility of going off entirely on the wrong track. Indeed, hardly had the papers of our experts and commentators been committed to print that the unexpected events in China raised the possibility of that country's political system opening to the principles of western world democracy with all the implications such a development would have for the international economic order. And what about the far-reaching developments in Eastern Europe only a few short months after the Conference, events that no one would have dared to predict? What then do we make of these visions of the future that forecast a gradual, progressive opening of the communist sphere to the rest of the world?

Of course, these are exceptional cases. The majority of the issues identified at the Conference have not changed and are unlikely to change in the next several years: world population growth and its inevitable impact on economic activity and the environment, the expansion of the industrialized world hand-in-hand with the continual impoverishment of the Third World, the creation of regional trading blocks, the pressures exerted on Canadian business and labour by an increasingly interdependent world economy, and so on. Even in the international political arena, our authors' observations have certainly not been overtaken by recent events. It is still worthwhile to try to assess the impact of such factors as rising literacy and educational attainment, greater access to information, and steadily growing respect for human rights. Can these factors hasten the downfall of autocratic regimes or give a boost to the world peace movement? What effect will the weakening of hegemonies and the emergence of a multipolar world have on the reorganization of our international institutions? These and many other factors form the backdrop against which government policy must be evaluated.

Our second objective was to go beyond economics per se to address questions related to geopolitics, demography, the environment, and science and technology. Perhaps most importantly, we also sought to examine the linkages among each of these areas. This objective was achieved for the most part. In fact, one of the points upon which there was general agreement was that, in attempting to map out the nature and goals of future public policies, our methodology must take into account a complex range of interrelated forces . In practical terms, this means that we must adopt a multidisciplinary approach and work to dismantle the barriers between professional disciplines. The Council has already begun to implement this principle by arranging for input from sociologists and political scientists for some current projects.



Jean-Pierre Voyer

In hindsight, it is interesting to note that, while it may have been relatively easy to bring together specialists from the social sciences and create the conditions for a certain osmosis between their world views, the project and the Conference failed to include the very people potentially able to make the critical link between our environmental, demographic, and economic concerns and science and technology – namely, scientists. Thus one lesson of this exercise is that the barrier separating the social sciences from the pure sciences remains a major stumbling block that we must overcome in order to arrive at a coherent view of our planet's evolution.

Finally, our third objective was to examine these issues not only from the Canadian viewpoint, but also in an explicitly global context. We discovered that the factors contributing to modern problems cover a formidable range: destruction of the ozone layer, the greenhouse effect and acid rain, independent multinationals immune from national regulation, the shortcomings of our international institutions, the increasing interdependence of international markets, and so on. More and more, today's problems fall outside the powers of the nation-state to solve.

Unfortunately, we were also forced to acknowledge that Canada is ill-prepared to deal with this new reality. Canada's sense of global awareness is still at an embryonic stage. It is very difficult for a country like ours to develop a global perspective when it is continuously preoccupied, as we are, with internal concerns related to regional equity or language. This penchant for soul-searching represents a considerable hindrance to the development of an outward-looking approach. What is even more discouraging is that our political institutions seem to be biased in favour of the current approach that focuses on federal-provincial relations and our internal divisions.

Curiously enough, although the problems between the levels of government were repeatedly raised during the Conference, the idea that Canada may be dismantled or undergo radical restructuring before the year 2000 never surfaced in the course of the discussions. At that time, no one would have dared to predict that negotiations for ratification of the Meech Lake Accord would take such a dramatic turn.

Regional seminar program

In the interest of reaching a wider audience of decision makers than simply those at the Conference, the Perspective team developed a brief summary presentation based on the major themes and questions raised at the Conference. This material was used in a series of eight seminars and workshops held across the country from May to November 1989. Most workshops were co-sponsored by other public and private organizations: the INRS (Urbanisation) in Montreal, the Atlantic Provinces Economic Council in Halifax, the Ministry of Economic Development and Trade in Edmonton, the Ministry of Regional Development in British Columbia, and the Association des économistes du Québec (ASDEQ).



These seminars provided the opportunity to reach a wide range of decision makers from provincial and municipal governments, the business community and the labour movement. For their part, Council staff members were able to forge new ties with these organizations and to deepen their understanding of the concerns of decision makers working at the regional level. Indeed, it became evident as the seminars proceeded that the visions of and worries about the future were most often simply an extension of current concerns. In the Atlantic provinces, the question of eventual annexation by the United States was frequently raised. The challenges of economic adjustment to a new world in the throes of change were also a prominent concern. We noted a firm desire to make the fishing and forestry industries more effective instead of simply diversifying the economic base. It was also interesting that participants expressed a real desire to free themselves from dependence on assistance programs, such as subsidies for businesses in difficulty and employment insurance, and to opt instead for an approach focusing on more effective management of natural and human resources.

In the West, participants were particularly struck by the demographic trends that foreshadow a most unequal distribution of the world's population over the surface of the globe and promise to have a significant impact on geographically large units such as Canada. It was interesting to note how a degree of tension is already making itself felt, most noticeably in British Columbia, between the achievement of economic and environment objectives. Labour and ecology groups have already clashed over two objectives that frequently find themselves in conflict: job security and the preservation of our natural resources.

The tense atmosphere surrounding labour relations and the need to make changes in order to meet the challenge of a fast-evolving world scene appeared to be of most concern to participants from the Atlantic provinces and from British Columbia. In Montreal and British Columbia, problems related to developing the labour skills needed to meet the requirements of the new labour market were considered paramount. In fact, this issue was a central concern across the nation; everyone agreed that human resource development would be crucial in a world marked by tough competition, growing technological complexity, rapid skill obsolescence, uncertainty, and the advent of various "shocks."

Positive spin-offs

From start to finish, Perspective 2000 was an extraordinarily enriching experience for all those participating, but especially so for the Council staff members directly involved. This project provided an unparalleled opportunity to expand our horizons. The themes and questions raised during this event will unquestionably influence the Council's research agenda for many years to come.

The economy and the media

One of the most critical factors in decision making is accurate information, and often decision makers go to the news media for a lot of their information. For economic information, the source is often the news media in its more specialized form, such as the business section of the newspaper or news program. But the general public also needs economic information, since economic affairs affect most of the population in one way or another. All of which is to say that accurate information about economic affairs is difficult to communicate, since the topic is often complex and abstract, while the effects are, more often than not, tangible and down to earth. Whether one develops a theoretical understanding of how the economy works, or a practical understanding of what forces shape the course of the economy, one still has to deal daily with economic issues. Recently, an effort was made to bring together some of the sources of economic information and some of the purveyors of economic news.

The old bromide has it that everybody talks about the weather, or at least complains about it, but nobody ever does anything about it. Be that as it may, there were several economic-oriented groups and institutes that did something for the news media last month, when they held an economic seminar for journalists. Sponsored and organized by the School of Journalism at Carleton University, the Institute for Research in Public Policy, and the Economic Council of Canada, the seminar attracted some 14 journalists to the Government of Canada Conference Centre in downtown Ottawa.

The goal of the exercise was to hold a seminar to provide journalists who cover the economic or business side of the news access to people who analyze the economy in its many facets. The goal was also to provide the news media with the opportunity to exchange with representatives of economic research groups, and use the opportunity either as professional development, or to learn who is doing what kind of research, or to have the chance to interact with each other and with the economists on a more informal basis on specific topics of interest.

In conclusion, it was all sorts of things for different people and was positively evaluated by the participants as worthwhile and useful. The range of presenters was such that the whole gamut of economic institutes, organizations, and councils was clearly on display. There were, of course, some that could not attend the seminar, but there will always be next year and the years following.

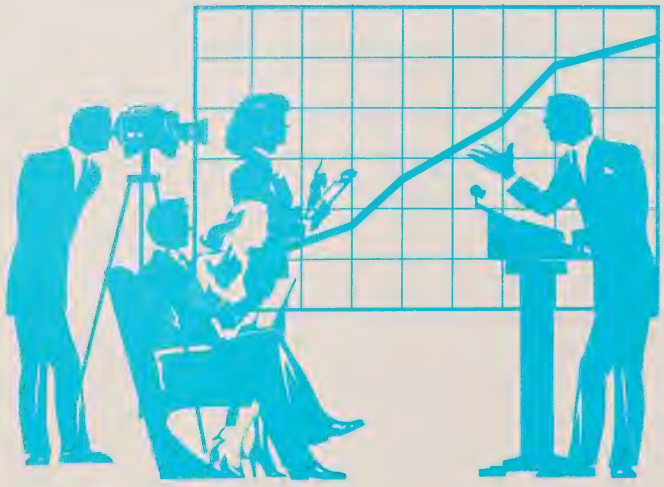
The Chairman of the Economic Council, Judith Maxwell, gave a brief talk at the dinner that followed the first day, where she discussed Canada's role in the evolving international economy from the changing face of Europe to the United States and to the Asian-Pacific developments.

It is hoped that such a seminar will become a mainstay of the Carleton School of Journalism, in collaboration with economic-oriented organizations, and that a variety of information exchanges can be developed over time, so that economic organizations become more aware of the news media and vice versa. If anyone has any suggestions or even a feeling that they would be interested in participating, in either attending or helping to organize next year's seminar, please write to: Director, Public Affairs, Economic Council of Canada, Ottawa, Ontario K1P 5V6.

The program was as follows, along with the list of journalists attending:

Presenters:
- C. D. Howe Institute
- Centre de recherche sur les politiques économiques
- Institute for Research on Public Policy
- Economic Council of Canada
- Fraser Institute
- Atlantic Provinces Economic Council
- John Deutsch Institute
- Centre de recherche et de développement en économique

Media representatives:
- Thomson Newspapers
- The Ottawa Citizen
- Le Droit
- The Ottawa Sun
- Radio-Canada (television)
- The Gazette
- Le Soleil
- The Toronto Star
- The Financial Post
- CBC Radio
- CBC Television
- Publinet
- The Globe and Mail



A question for the 90s

"Competitiveness." That is the watchword of experts who are attempting, at the dawn of the 1990s, to gauge Canada's chances of success on an international economic stage where competitors are striving to be bolder, more innovative, more dynamic and, above all, more efficient than their rivals in order to garner larger shares of world markets.

For many, the key to the enigma and the main factor in Canadians' welfare in the run-up to the 21st century is *education*. Clearly, productivity and competitiveness are by no means the only – perhaps not the most important – goals of the education system. A wide range of social and cultural outcomes of the education process are no less worthy, and the pursuit of knowledge is also an end in itself. Nevertheless, the majority of our young people are destined for the work force, and it is therefore critical that their transition to the workplace should be successful, and their subsequent experience rewarding. And because of the rapidly evolving skill and knowledge content of jobs in the "information economy," the question of education has been thrust increasingly into the forefront of concerns. True, education has already been the subject of extensive public debate, but there are still important gaps in our basic knowledge. And filling those gaps is what the Economic Council hopes to accomplish with its new research project on education.

How good is the education received by our children at all levels of the system? What lies behind the high drop-out rates from our high schools? What guidelines should we follow in an era of government belt-tightening? Occupational training seems to have some serious deficiencies, but how can it be improved? How qualified are our educators? How does Canada compare with other industrialized countries?

The challenge is certainly great. The above questions and many others will be investigated by a research team headed by Keith Newton, Senior Research Director at the Council. To find out more, *Au Courant* recently interviewed Mr. Newton.

Au Courant: *What led the Council to undertake such a project?*

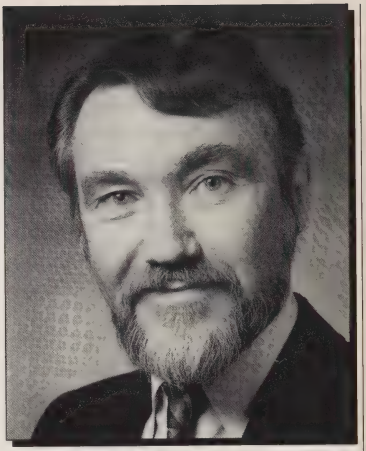
Newton: In fact, the Council has a long history of research in the field of human resource development starting with its work on the contribution of education to economic growth back in 1964. The Council has, at various points in time, revisited the question of education and training. I might mention, for example, the Eighth Annual Review of the Council in 1971, which looked at a variety of human resource policies and programs. Then, of course, most recently, our work on new technologies and their impact on the labour market, and the work that we have done on employment in the service economy, had quite a lot to say about the implications of such economic changes for education and training.

Au Courant: *Because education is a vast area, will you focus on certain specific aspects?*

Newton: You are right, it is vast, it's complex, it's very contentious, and it's probably one of the most important public policy issues facing this country at the moment. Inevitably, we will have to focus on certain particular dimensions. However, we do want to be as comprehensive as possible, and we are very mindful of the fact that education is a cumulative process; so we will in fact look at a very broad range of educational levels all the way from kindergarten right through to the post-secondary system. In particular, we will be looking at some of the implications of recent structural changes for so-called "continuous learning."

Au Courant: *Do you have specific objectives in mind?*

Newton: As a matter of fact, I think that you could probably express our major concerns in terms of two specific themes. First of all, there is the question of quality. One can hardly pick up a newspaper these days without reading that the education system is in a crisis of some kind. And therefore I think it's very important to look at some of the



Keith Newton

indicators – some of the measurement indicators – of this whole question of quality in order to make a good, solid empirical assessment of the state of Canadian education. But, secondly, I think, given the fact that governments at all levels are facing fiscal constraints, the question of the efficiency of resource allocation in education has to be a very important topic as well.

Au Courant: *Have you identified the main deficiencies of the system? How do they appear?*

Newton: Well I think there are certain deficiencies that are pretty clear to everyone. I want to make the point that it is not all "doom and gloom," but there are certain aspects that give us considerable cause for concern. One of the major examples would have to be the drop-out rate from high schools. We do not have very good data on this particular phenomenon, but many estimates suggest that as many as 30 per cent of our high school students are dropping out before completing their studies. That is certainly one major cause for concern. Secondly, we hear from institutions of higher learning and also from employers that many Canadians are not equipped with basic skills; so there are some very important concerns about literacy and numeracy, for example.

Au Courant: Are there sufficient funds allocated to education or are the problems mainly structural?

Newton: That is a very difficult one to answer at the moment; it is one that we will be looking at with some care. The debate still rages as to whether we need to allocate more and more funds to what is, after all, a very fruitful investment. However, it may be that there is some scope for more efficient utilization of existing funding levels, and also for the exploration of new alternative funding sources. So we will want to do some very careful empirical analyses to come to grips with this particular question.

Au Courant: Is the question of the cost of education being examined by your group?

Newton: Yes, I think that that is one of the most important research areas. As I mentioned, governments are under increasing fiscal constraints, and one of the major public policy issues of the day is how to maintain the level and the quality in the provision of social services of various kinds and education in particular.

Au Courant: Should the education studies spill over into other aspects of the economy such as regional development and poverty?

Newton: It is quite clear that education and training are widely regarded as one of the key elements in general economic competitiveness, productivity, and economic development generally. As to the specific questions that you posed, the regional dimension of education and training performance is something that we will want to examine. For example, we will try to assess the relative performance of various provinces, since it is clear that successful development of Canada's diverse regions will depend critically on the skills and training of their people.

Au Courant: Will you be looking at training and development in your research studies?

Newton: Training in the workplace has been identified as one of the most important aspects of human resource development generally. While it is pretty well acknowledged, I think, that certain aspects of our education system are regarded as excellent in international comparisons, this is not always true of our training in industry. Many people point out that we do not have a so-called "training culture" in this country, and that is one of the charges that we will examine in some depth.

Au Courant: Will teacher training and education be a part of your research work?

Newton: You will recall that I mentioned that quality is one of the dominant themes of the whole study, and therefore, part of our research will attempt to identify the determinants of success in the education system. Clearly, the excellence of our teachers is a very important ingredient of that success, and therefore, we will want to examine the preparation of our teachers and the specific needs for their skills in the future.

Au Courant: Will you be making any comparisons as to how well we fare with other countries?

Newton: As a matter of fact, we have some very interesting and very important work already in train. We have commissioned two studies on international comparisons of educational achievement among high school students in a variety of countries in two areas. First of all, in mathematics and, secondly, in the sciences. Those studies have been completed, they have already been refereed, and we expect to publish them very shortly.

Au Courant: Will you be assessing the differences in quality levels in education among the different regions within the country?

Newton: Yes, that is another very important aspect of the measurement of performance. We will be looking at data that provides information on educational attainment of Canadian students in a variety of disciplines across different provincial jurisdictions.

"One can hardly pick up a newspaper these days without reading that the education system is in a crisis of some kind."

"Many people point out that we do not have a so-called training culture in this country."

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PUBLICATIONS

Council Report

From the Bottom Up – The Community Economic-Development Approach (EC22-170/1990E; $4.95 in Canada; US$5.95 outside Canada).

From the Bottom Up examines the experience of community-based economic development initiatives in Canada. It highlights the business orientation adopted by many local development organizations (LDOs) and shows how this can play a positive role in local communities' efforts to break out of situations of economic stagnation and dependency. The report concludes that community economic development merits public support and recommends ways in which this can be best provided.

Research Studies

Structural Change and the Adjustment Process: Perspectives on Firm Growth and Worker Turnover, by John R. Baldwin and Paul K. Gorecki (EC22-166/1990E; $20.95 in Canada; US$25.15 outside Canada).

This new study advances the understanding of the extent, nature, and patterns of adjustment in the Canadian labour market, particularly in the manufacturing sector.

Two Steps Forward – Human-Resource Management in a High-Tech World, by Gordon Betcherman, Keith Newton, and Joanne Godin (EC22-169/1990E; $5.95 in Canada; US$7.15 outside Canada).

Innovation is widely regarded as the key to productivity and competitiveness in the global economy of the 21st century. Innovation involves technological advance coupled with imaginative human-resource development. It also means changes in the structure of organizations and the functioning of workplaces. These case studies of Canadian organizations cover a broad spectrum of industries, a variety of technologies, and illustrate different aspects of the human and organizational components of innovation and change.

Colloquium Proceedings

Perspective 2000 – Proceedings (EC22-167/1990E; $32.95 in Canada; US$39.55 outside Canada).

In an attempt to identify some of the public policy issues of the turn of the century and beyond, Perspective 2000 presents the "visions" of experts in a variety of fields.

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Transitions for the 90s



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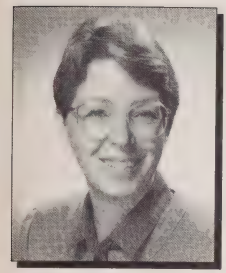
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Difficult "transitions" – The 1990s



Judith Maxwell

The Council's 1990 Annual Review, entitled *Transitions for the 90s*, highlights three factors that make the Canadian economy difficult to manage.

First, there are big differences in regional economic structure. Ontario, for example, can be running well above capacity, generating strong inflationary pressures, while other provinces are lagging far behind. These regional differences can have positive effects, since the regions can help to stabilize each other, but there is also a possible negative. Overheating in one region, particularly a large province like Ontario, can cause national policies, such as monetary policy, to become restrictive, even though that policy may not be the best choice for other regions.

Second, there are signs of rigidity. Some sectors and regions have had a lot of trouble adapting to the shock waves from the world economy in the 1980s. This shows up in the growth in long-term unemployment, particularly in western Canada. Such rigidity is particularly disturbing, when we consider the incessant pressures for change that lie ahead in the 1990s. With the move to greater integration in Europe, reforms underway in the Soviet Union and Eastern Europe, and the emergence of strong competitors in the Pacific Rim, it seems inevitable that the patterns of world trade will change dramatically in the years ahead. Will Canadians be able to cope with the job changes that this entails?

These rigidities make management of the economy more difficult. For example, when policies attempt to reduce inflation, it takes a long time for firms and workers to respond in sectors and regions that are less sensitive to market forces – in the 1981-82 recession, the peak in wages was not reached until 18 months after the unemployment rate started to rise. These long reaction times make it difficult for monetary policy to curb inflation pressures.

The third difficulty is the fragmented decision-making structures in the public and in the private sectors. Because there are no institutions for joint problem-solving, we are frequently forced to resort to bouts of monetary restraint in order to fight inflation. This, obviously, has consequences for output and unemployment.

These obstacles to economic management are particularly damaging at the beginning of the 1990s, when Canada faces exceptionally tough choices on the immediate direction of economic policy. The federal government is seriously handicapped by a mountain of debt (see the speech on the deficit virus reported in this issue) as debt service continues to swamp all other priorities. Thus, the government has no choice but to continue the battle to control the deficit. In the meantime, the Bank of Canada has been leaning hard against inflation expectations for nearly two years – pushing "real" interest rates even higher than in the credit crunch in 1981. These interest rates make deficit reduction exceptionally difficult, and, because the economy appears to be entering a recession, higher unemployment is in the cards.

The Council insists that we cannot abandon the fight against inflation. It is a vital element of future prosperity. But the Council argues that the Bank of Canada should not be left alone in the fight against inflation. The cost of disinflation can be significantly reduced if Canadians make deliberate efforts to overcome the three difficulties mentioned earlier. In general, this requires a collective commitment by the three social partners – government, business, and labour.

If business and labour become partners in adjustment, workers will be better equipped to cope with job changes. This will achieve the equity goal of reducing long-term unemployment, as well as the efficiency goal of improving our capacity to adapt to new market threats and opportunities. Becoming partners in adjustment involves many changes in the way business and labour interact. The Council supports the idea, for example, of delegating the responsibility for the design and delivery of training programs to business and labour leaders. Also, much more innovation is required within the workplace. Later in this issue you will find a report on a number of case studies of the impact of technological change on the workplace – see *Two steps forward*.

If governments curb their own contribution to the inflation process and *if* wages become more responsive to the business cycle, then the Bank of Canada will find that it has more partners in the process of fighting inflation.

If federal and provincial governments can establish a system for better co-ordinating their fiscal policies, such that provinces with overheated economies take more responsibility for disinflation, then the pressure on federal finances and monetary policy will be reduced.

The underlying message of *Transitions for the 90s* is that Canada needs to work on the decision-making process. We need to set some goals and build pathways to achieve them. If we continue to rely upon the existing technocratic and fragmented approaches to the formulation of economic policy, we cannot achieve the kind of economic performance that we wish to achieve for ourselves and for future generations.

In effect, the inflation-unemployment dilemma which we now face demands that all decision makers search for ways to reduce the inflationary pressures in the Canadian system and to help firms and individuals to adapt to the new patterns of world trade.

A two-pronged transition

As Canada enters the 1990s, it faces extraordinary challenges at home and on the international scene.

To ensure the future prosperity of the economy, Canadians will have to successfully manage two crucial transitions:
– industry and workers must adapt to new markets and to the new trends in international trade; and
– Canadians will have to find new methods for reconciling such national priorities as controlling inflation, reducing unemployment, and curbing the federal deficit.

If Canada is to successfully take on the challenges of the 1990s, governments must rethink and coordinate their economic policies. Canadians, for their part, must agree to change their attitudes and patterns of behaviour, both individually and collectively, in a concerted effort to improve the employment situation in the country.

That is the crux of the message delivered by the Economic Council of Canada in its 27th Annual Review entitled *Transitions for the 90s*, in which it also sets out a number of policy options intended to help Canadians to achieve these objectives.



The changing global situation

Constant change in the world economy promises to have a significant impact on Canada's trade and employment patterns.

One need only look at the sweeping changes unleashed by the economic integration of Europe in 1992, which will create a single market of more than 320 million people. The collapse of the Berlin Wall in late 1989 symbolized the release of powerful new forces that will shape the future development of the world economic system.

The countries of the Pacific Rim, meanwhile, are following in the footsteps of Japan, making significant inroads into the world economy.

The Uruguay Round of GATT negotiations, which is scheduled to conclude in December 1990, will also have profound implications for Canada's access to markets and for the rules that govern international trade.

How ready are Canadians to face these new economic realities? These imposing challenges arise just as economic growth is starting to falter and when Canadians might be tempted to turn inward out of preoccupation with questions of national importance such as the recent failure of the Meech Lake Accord, stormy relations with the country's native people, and so on.

Canadians can not afford the luxury of allowing gripping domestic issues, important as they may be, to blind them to the dramatic changes that will be taking place in overseas markets in the 1990s.

The Council notes that Canada has already taken some steps towards putting its economic affairs in order so as to become more competitive globally, such as the free-trade agreement and the proposed goods and services tax (GST). These two measures are specifically designed to make life easier for exporters and for domestic firms that compete with imported products.

Yet much more remains to be done before Canada will be able to offer a new array of high-value-added goods and services or to export the kind of high-quality products at competitive prices that will allow it to compete successfully in world markets.

The changing pattern of exports and imports since the early 1980s is having a profound impact on the composition of employment in Canada. Jobs are disappearing in the primary and manufacturing sectors and being created in the service sector. While unemployment is no more severe now than in the late 1970s, many workers are now experiencing much longer spells of unemployment than was previously the case. This phenomenon is caused, in part, by social ties, but it is reinforced, stresses the Council in its Annual Review, by government policies intended to preserve a traditional way of life.

"Thus we have been faced with the paradox of an economy charging ahead at full capacity while unemployment rates fluctuated in the 7-to-8-per-cent range," notes Council Chairman Judith Maxwell in the Foreword to the Review.

Yet, during the same period, certain countries managed to control inflation while keeping unemployment rates low. They relied on cooperation among governments, business, and labour unions.

While recognizing that there is no universal model that could be directly transplanted to Canadian soil, the Council endeavours in its Annual Review to learn from the successes of other countries. This can help Canada to forge new attitudes and new institutions that will make the fight against inflation less painful, and allow Canadians to make progress in reducing unemployment at the same time.

The Review Team

The Review was prepared under the direction of Senior Research Director Ross Preston. He was assisted by Deputy Director Jean-Pierre Voyer. Other participants were the Performance and Outlook Group with Richard Roy, Deputy Director, Andrew Burns, Bobbi Cain, Pat Nevin, Haider Saiyed, and Marg Willis; the Unemployment Issues Group with Surendra Gera, Project Leader, Miles Corak, and Sajjad Rahman.

Rethinking attitudes and strategies

"The transition to a more effective economic policy framework can only come about if federal and provincial governments, along with business and labour leaders, are prepared to admit that there is something fundamentally wrong with the way we have tried to solve economic problems in the past."

With these blunt words, the Economic Council of Canada lays bare, in its 27th Annual Review, the shortcomings in the traditional approaches to economic management followed by Canadian governments and sets out some options that will help them to deal more effectively with the twin economic problems of unemployment and inflation.

The Council argues Canadians must make a collective and individual decision to change their attitudes and to embrace change rather than considering it a necessary evil. They must also adopt a more mature attitude by accepting their fair share of the responsibility for developing and implementing the kind of measures that will help Canada to successfully weather the crucial transition to a policy framework suited to the economic realities of the 1990s.

As well, stresses the Council, the various levels of government must strive for better coordination in their efforts. Business, too, must participate more actively in economic management, rather than leaving the full burden of responsibility for overall economic management on the shoulders of governments, as they have tended to do in the past. They themselves will reap the benefits – in the form of a competitive edge on international markets – of greater investment in training, the environment, and the basic elements of infrastructure, such as telecommunications. For their part, workers must agree individually and collectively to learn new skills and to participate through their labour unions in a process of social and economic partnership that will confer greater flexibility on economic development initiatives.

Economic rigidity

There are a number of signs that the Canadian economy is experiencing difficulty in adjusting to the new economic context: high unemployment, longer unemployment spells, and pockets of chronic unemployment.

Canada is clearly having a tough time keeping up with the changing nature of the labour market; one indication is the persistent rise in unemployment since the 1940s, despite strong job creation. The unemployment rate has risen from an average of 4 per cent in the 1950s to 6.7 per cent in the 1970s and 9.3 per cent in the 1980s, although it has stayed under 8 per cent in the past two years.

In June 1990, over one million Canadians – 7.5 per cent of the labour force – were unable to find work. Since then the rate has risen to 8.3 per cent.

The persistence of unemployment in the face of external shocks has never been more evident than in the 1980s. Sooner or later, shifts in the composition of exports and imports, in consumer preferences, and in production technology are reflected in the jobs available to Canadians.

The signs of a failure to adjust smoothly are even more evident when seen from a regional perspective. Whereas in Ontario the unemployment rate averaged 5.5 per cent during the first half of 1990, in the rest of Canada it did not fall below 8.8 per cent. Not only is there a substantial difference between the highest and lowest regional rates, but there has been no decline in these disparities over the past 15 years. Thus, states the Council, we are not facing a short-term difficulty, but a deep-seated, chronic problem.

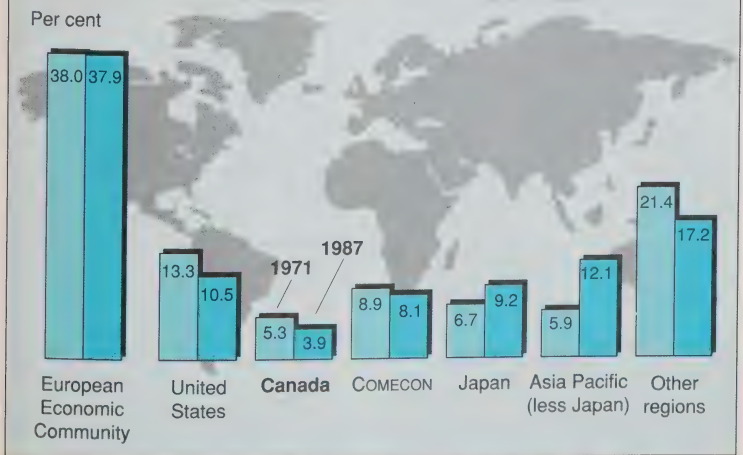
Work done by the Council during the past year throws new light on the importance of economic structure in explaining regional disparities in unemployment rates. For example, structural unemployment declined in Quebec between 1981 and 1986, reflecting a 10-year period of economic renewal; over the same period, it increased in British Columbia, because workers had still not completely adjusted to the modernization of industry triggered by the commodity price shocks and recessionary conditions of the early 1980s.

In Saskatchewan, economic structure accounted for more than half of the unemployment rate disparity with Ontario in 1986. That province (and, to a lesser extent, Alberta and Manitoba) was hit hard by a combination of drought, high interest rates, and falling world grain prices.

In Newfoundland, economic structure accounted for about two thirds of the gap in unemployment rates vis-à-vis Ontario in 1986.

There is no question, says the Council, that the marked differences in economic structure between the regions of Canada make the country more difficult to govern.

Regional Shares of World Exports, 1971 and 1987



However, the majority of workers do make a successful transition between jobs, spending little or no time unemployed. Of successful job finders interviewed in 1986, about one third moved directly from one job to another, with no time spent unemployed; another 30 per cent found a job within four weeks of leaving the previous one. In both cases, successful job changers were most often people who:

– had quit their jobs voluntarily;
– lived in Ontario (with Quebec a close second);
– were males, aged between 25 and 44; and
– changed jobs within the same industry.

Conversely, the least successful job changers were most often those who:

– had been laid off;
– lived in western Canada or the Atlantic provinces;
– were over 45 years of age;
– were women; and
– changed to a new industry.

Other studies have shown that the greatest degree of hardship – unemployment for more than half a year – is concentrated in a relatively small group of people who account for 6 per cent of the labour force. This group, in fact, accounted for 29 per cent of all unemployed individuals in 1986 and for 60 per cent of all the time spent unemployed during that year.

Lessons to be learned

Current unemployment-fighting tactics have tended to focus on income-support programs, which are designed not to eliminate unemployment but to lighten the burden on those it touches directly.

Similarly, the setting of national economic policy is based to this day on the technocratic approaches that developed in the late1940s. What has evolved since then is an approach where governments now rely heavily on restrictive monetary policy to fight inflation while unemployment as national concern has become a poor relation.

Yet certain countries – Austria, Sweden, Norway, and Japan, in particular – have managed for more than 20 years to contain inflation without creating unemployment.

The Council does not advocate borrowing an existing model and applying it outright in Canada. That would be a simplistic approach. Economic policy, like all policy decisions, is influenced by a number of national factors – culture, tradition, and so on. It may be possible, however, to draw some lessons from a comparison of the approaches of these countries to the quest for full employment with the Canadian experience.

The same is true of strategies for fighting unemployment and inflation. Despite the wide differences among the countries mentioned, it is possible to identify some common characteristics that may explain why these countries have had more success in fostering labour force adaptation and achieving full employment.

Full employment

The countries that have achieved full employment have made it their primary policy objective. This is true not only of their governments but also of the other social partners involved – labour and business. This significant commitment shapes the attitudes, actions, and behaviour of all the partners.

For governments, employment becomes a prime consideration when decisions are made regarding new economic or legislative initiatives. For labour unions and employers, putting the priority on employment necessitates some changes in behaviour. For example, they must take into account the repercussions of price and salary increases on employment.

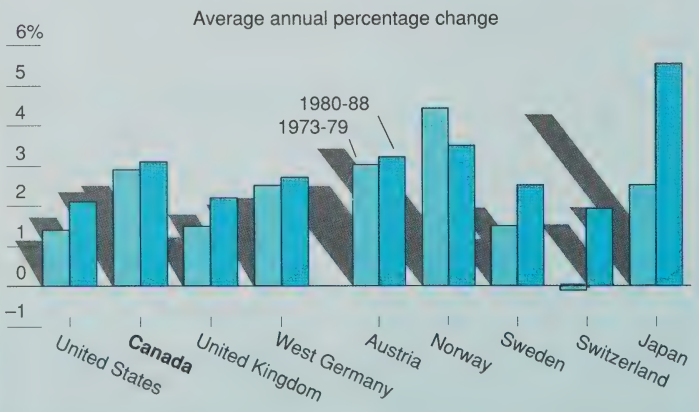
However, notes the Council in its 27th Annual Review, it is not enough simply to make full employment a priority. Besides the political will, there must also exist a suitable institutional framework for achieving this goal.

One of the basic common traits in the experiences of these countries is the search for consensus among the social partners to support economic management and the full-employment strategy. For this cooperative process to work, of course, labour and management organizations must exist that are highly structured, centralized, and equipped with the authority to speak on behalf of their members.

Tripartite management has the advantage of letting responsibility devolve to local groups and actors, thereby improving efficiency.

In Canada, the strongest commitment to full employment came with the

Real GDP Growth per Capita, Selected Developed Countries, 1973-88



publication of the White Paper on Employment and Income in 1945, which laid out the economic strategy of the federal government for the postwar era. Even in those times, there was reluctance to speak of full employment; the preferred expression was "high levels" of employment.

In 1975, the fight against inflation became the overriding objective on the political agenda. In the early 1980s, the Canadian government adopted monetary policy so restrictive that the only possible outcome was a recession. The bank rate climbed to 21.2 per cent. The rest of the story is well known: unemployment rose by 4 percentage points within a few months, and the inflation rate fell from 12.5 per cent in 1981 to 5.8 per cent in 1983.

At the moment, there are no participatory mechanisms in the public or private sector for developing general economic policy in Canada. European-style social partnership has simply never taken root here, although some recent Canadian initiatives in that direction have produced some encouraging results. The following are good examples:

– The Canadian Labour Market and Productivity Centre (CLMPC) which provided productive dialogue between authorities responsible for labour market policy and business, labour, and other private sector representatives.

– In Quebec, 12 regional forums and a province-wide forum on employment were held during the summer and fall of 1989.

– In British Columbia, the B.C. Task Force on Education and Training, composed of representatives of labour unions and employer organisations, was mandated in August 1989 to review employment- and training-related issues and submit recommendations to the provincial government.

– In Ontario, the Premier's Council has advised the government to delegate responsibility for training and other labour market programs to an Ontario Training and Adjustment Board, composed primarily of business and labour leaders.

The Council says, finally, that the current rate of unemployment is neither acceptable nor unavoidable. It stresses that alternatives to the current strategy must be explored so that the control of inflation and the pursuit of full employment figure side by side as top economic priorities of government in Canada.

Performance targets

To examine what possibilities exist for pulling Canada out of its present dilemma, the Review looks at the trade-offs between different policy strategies by asking a number of "what if" questions. Using an econometric model, researchers assessed the way in which certain policy choices would affect the economy over the next five years.

The questions posed were:

– What would be the consequences of a sharp spike in interest rates if the strength of demand led Canadian monetary authorities to take a more cautious approach towards inflation pressures?

– What would a sharp recession mean for Canada during the current period of adjustment?

– What would be the implications of reaching an interim target of 3 per cent for inflation if wages and prices were more flexible?

– How much has the fiscal action of recent federal budgets actually contributed to deficit reduction?

– What would be the impact of an easier monetary policy?

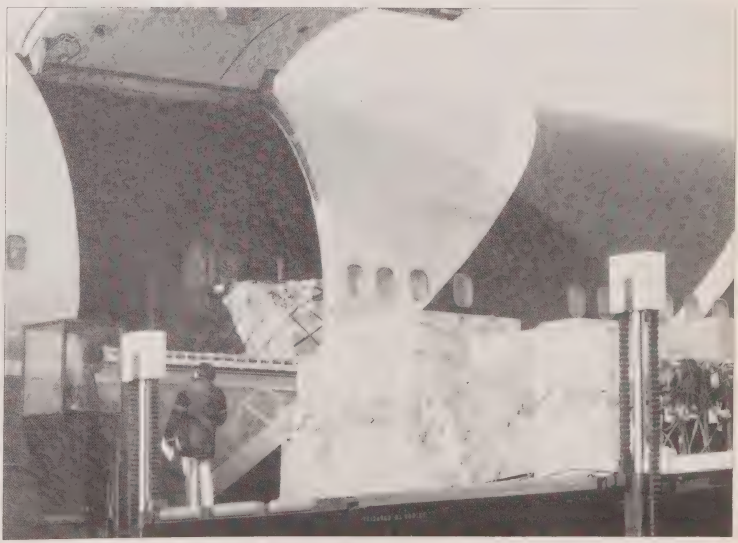
Damage to the economy, in this year's base case projections of the Review, are controlled by a moderation in monetary policy combined with a more favourable international environment.

Even this scenario, which is the best that can be hoped for under current circumstances, produces, according to the Council, results that fall well short of the desirable targets.

The situation is not entirely gloomy in the base case. Growth in productivity, employment, and output is close to the target ranges for the period 1992-95, when the economy returns to more normal growth rates.

What is unsettling, however, is that there is a serious possibility that even this relatively unsatisfactory performance cannot be achieved. Conditions in the world economy – rising interest rates and uncertain oil prices, plus the risk of a recession in the United States – raise the probability of a serious setback in economic growth.

When we attempt to sketch out policy options here in Canada, we encounter a logjam that cannot be broken, concludes the Council, without a change in expectations and attitudes.



The Canadian economy depends strongly on export markets.

Regional economic structures and labour markets

A search for new options

The search for solutions to improve Canada's ability to react appropriately to the structural changes of the 1990s and the development of a policy and institutional framework to replace our current strategy must focus on regional economic structures and the operation of the labour market.

To reduce unemployment, ways must be found to improve the capacity of Canadians to adapt to the dramatic changes taking place in the world economy, as stated previously.

In its analysis of the economic challenges facing Canadians over the next several years, the Economic Council states that its objective is not to propose a comprehensive blueprint, but to identify a range of options and point out the inherent obstacles.

Four ingredients are necessary to improve the adjustment capacity of the economy:

– active labour market programs;
– a change in mindset on the part of workers, business, communities, and governments;
– a partnership among the socio-economic players that delegates the responsibility for labour market programs to labour, business, and other economic agents; and
– a set of monetary and fiscal policies that work together to create a healthier economic environment.

Stronger regional economies

Strengthening the economic base of high-unemployment regions must remain a central objective of Canadian economic policy. Thus the Council supports the federal government's current strategy to promote diversification of the regional industrial base. Much more must be done, however, before these efforts at diversification can be termed a clear success.

One obvious priority is to ensure that the appropriate technological infrastructure is in place to enable individuals and firms in the regions to communicate with customers and suppliers in all parts of the world. Another is to make sure that workers are properly trained to use these technologies, no matter what industry they work in. Human capital in technology-driven activities is increasingly becoming a decisive factor in economic performance. Provinces must do their share by investing in upgrading their education systems and training and retraining programs.

Another priority is dismantling the barriers to innovation in the regions, i.e., obstacles that impede or prevent the start-up of new businesses. For example, unemployed workers who chose to start their own business were, until very recently, ineligible for unemployment insurance benefits. Studies in France and the United Kingdom have shown that between 50 and 60 per cent of participants in such schemes remain in business longer than three years.

Echoing a recently published Statement, the Council also questions the effectiveness of ad hoc, bureaucracy-driven plans for regional development. Such top-down programs have fallen into disrepute. Policymakers are now paying more attention to the harnessing of local talents, expertise, and resources. The aim is to enable citizens to take charge of the economic well-being of their own communities.

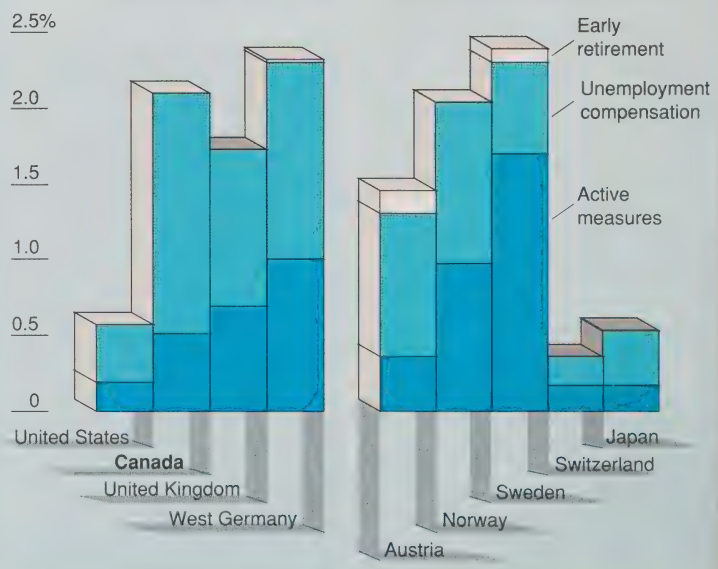
Labour market policies

The key to adjusting efficiently to new trends in the world economy and to guarding against unforeseen shocks still lies with a labour force that is flexible, mobile, and ready to adjust to new jobs and to acquire new knowledge and skills.

A new policy for the labour market, therefore, should include the following elements:

– a move from income support towards more-active labour market policies;
– special attention to the employability of disadvantaged groups;
– more input from labour and business and from local communities in the design and delivery of labour market programs; and
– the adoption of workplace practices aimed at fostering internal adjustment.

Public Expenditures on Labour Market Programs, Selected Developed Countries, 1989



While passive income support is a necessary element of the social safety net, the Council believes that it must be combined with active measures that help workers to adapt to a changing world. Some recent initiatives seek to widen the conditions under which unemployment insurance (UI) recipients would be eligible for training. Canadians have not yet transformed UI into a truly active labour market program, however. Much more remains to be done.

Workers must also come to appreciate the importance of acquiring new skills and maintaining an open mind about new careers. Parents and communities must, among other things, discourage young people from believing that being fishermen or farmers, generation after generation, is their preordained destiny – one that the state must accept without challenge.

Canadian firms must give a much higher priority to worker training. Currently, they are spending approximately $1.4 billion on training. On a per capita basis, this represents less than half of what U.S. corporations spend.

Flexibility in the workplace

The way in which labour is reallocated within firms in response to foreign competition is of great importance for the process of adjustment.

One important way to encourage greater efficiency and competitiveness is through new approaches to work organization, labour relations, decision-making structures, and management style.

Innovations of this kind over the past few years have often met with scepticism from workers and unions, since in some cases they were an ill-disguised attempt to keep the company or plant union-free. Successful innovation depends on a determined effort to build channels of communication that promote mutual trust within the firm.

One innovation that has gained attention is the shift from fixed wages to contingent-payment schemes whereby employees' wages are linked to the firm's profits, the work unit's productivity, or a worker's skill attainment. The Council recognizes that these plans have not proven popular in Canada. In fact, broad diffusion of contingent-pay practices is unlikely to occur unless they are accompanied by changes in management practices aimed at gaining and sustaining workers' trust. These systems require, notably, the sharing of more information on current financial performance and future business plans.

Work organization and practices represent another prime area for innovation aimed at overcoming the inefficiencies associated with rigid and narrow job classification. However, workers have traditionally viewed the rigid delineation of jobs as a necessary condition for the proper operation of the seniority system, which is now the primary determinant of wages and employment security in most firms. Alternatives to the seniority system will have to be found in order to provide the employment security sought by workers without handicapping firms with rigid job classification systems.

In short, partnership may have its biggest role to play at the firm level.

Social partnership

The development of social consensus and the adoption of guidelines of a voluntary incomes policy should perhaps be a key component of anti-inflation strategy.

Tripartite systems based on central bargaining and compromise among the social partners – business, labour, and government – over a wide range of economic policy issues seem to offer the best hope for controlling inflation without creating an unacceptable level of unemployment. Although the schemes used in other countries differ in important ways, they all rely on a form of voluntary incomes policy.

The tripartism needed to implement such a policy simply does not exist in Canada, where Canada's economic and political institutions are characterized by fragmentation. Power is shared among various levels of government, and there is no single organization that can speak for labour organizations.

That is not to imply that partnership is a dead issue in Canada, says the Council. Partnership can play an important part in improving Canada's capacity to adjust to the new realities.

But a voluntary incomes policy can only be successfully introduced, concludes the Council, once new relationships have been forged and social partnership becomes an accepted institution in the country.



A coordinated approach by all Canadians will be necessary to confront the transitions of the 1990s.

A new economic policy framework

If there is one lesson to be learned from the economic policies of the 1980s, it is that fighting inflation through the exclusive use of monetary policy is very costly. Thus the efforts of the central bank should be supported by governments, business, and labour.

In its 27th Annual Review, the Economic Council proposes a long-run objective of improving the efficiency of markets to allow unemployment rates to drop below 7 to 8 per cent before inflation pressures begin to emerge.

It will not be easy to achieve this goal. As already discussed, fighting inflation effectively will require both revamped weapons and specific targets that are coordinated and credible. It hardly need be added that Canada's diverse nature and sheer size complicates action in this regard. The wide variation between regional economies across the country means that a national policy that improves the situation in one region often creates new problems elsewhere.

This fact casts serious doubt on the wisdom of relying too heavily on restrictive monetary policy to fight inflation. A recent example: when the federal government tightened monetary conditions in an attempt to counteract overheating in the Ontario economy, one unfortunate consequence was to aggravate problems in the West, still recovering from the effects of the recession.

Statements by the Governor of the Bank of Canada and the Minister of Finance help to shape the behaviour of business executives who exercise some control over the determination of wages and prices. But their statements are unlikely to influence the expectations of the general public or to have any direct influence on workers' wage demands. For the majority of Canadians, expectations about inflation are based more on everyday experience than on official pronouncements.

The Council also singles out for disapproval the lack of consistency between the actions of governments at all levels and the statements made by the Governor of the Bank of Canada. Many public officials do not take stock of the impact of their decisions on the rate of inflation. "They do not realize," states the Council, "that they are undermining the credibility of the stated objectives of the monetary authorities by creating a state of confusion in the public's mind that tends to entrench inflationary expectations and, in turn, to make monetary policy more restrictive than it need be."

New institutional arrangements

New institutional arrangements will be essential during the period when the main focus of the federal government's fiscal policy will be deficit reduction. In the longer term, these ideas may well provide the foundation for a new approach to the formulation of economic policy in Canada. The key elements of these new arrangements are:

- a credible approach to inflation targets;
- a coordinated inflation target;
- a coordinated fiscal policy;
- more responsive wages; and
- a framework for social partnership.

The Council believes that controlling inflation is a policy objective that benefits Canadians in all walks of life. This is especially true for those on fixed incomes or with limited bargaining power, as well as for firms and workers who must compete in international markets.

This implies that *all* Canadians should strive to avoid placing unnecessary pressure on prices and costs.

These observations lead the Council to two main conclusions about anti-inflation policies:

- the Bank of Canada's objectives must be both clearly defined and perceived as feasible in the medium term; and
- all levels of government and all public authorities must assume greater responsibility for controlling inflation.

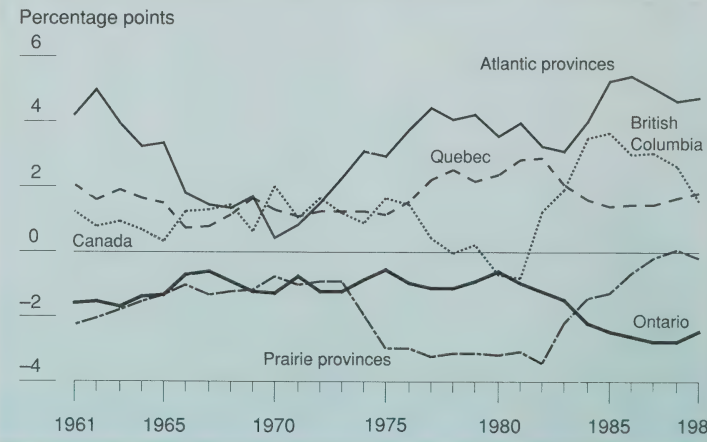
Meetings of federal and provincial finance ministers, or possibly First Ministers themselves, would be the appropriate forum for working out the guidelines for public-sector decisions on government charges (taxes, prices, user fees) and regulations.

At the same time, each provincial legislature should establish a standing committee with a mandate to review any decisions within its jurisdiction that appear to exceed the guidelines established at the ministerial level.

While, naturally, there are some risks involved in this approach, it offers the distinct advantage of ensuring that government decisions "lean" in the same direction as monetary policy.

The Council also argues that, if prices and wages would react more quickly to

Difference between Provincial/Regional and National Unemployment Rates, Canada, 1961-89



tighter monetary conditions, it would not be necessary to depress production and employment for such long periods. During the last recession, for example, wage increases did not begin to decline until 18 months after unemployment had begun to rise.

Part of the blame for this inertia rests with the collective-bargaining process. Collective agreements often cover two- to three-year periods. Only a small number of wage contracts are negotiated in any given year, and they take into account the economic conditions prevailing at the time.

Shorter contracts and synchronized collective bargaining, even within a system of decentralized collective bargaining, would help to reduce the rigidity of wages and prices and to increase employment stability.

Recognizing that this system would present its own inherent problems, the Council suggests a possible compromise solution: keeping long-term contracts for nonwage benefits, with a provision for yearly negotiations on wages only.

The Council also points to gain-sharing plans as a way to increase employment stability.

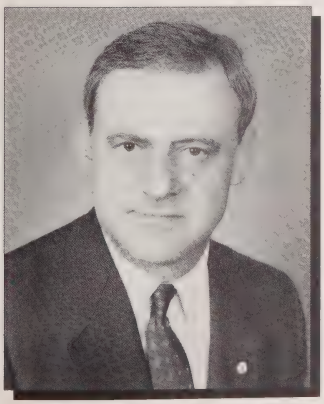
Lastly, coordinated fiscal policy can play an important role in the fight against inflation. "Why slow down the country as a whole when the source of the inflation is localized?"

An important step in this direction would be to encourage provincial governments to assume greater responsibility for the fight against inflation through their own fiscal policies. Policy coordination could also extend to municipalities, whose budgetary envelopes will continue to grow in response to the rising demand for services on the part of their residents.

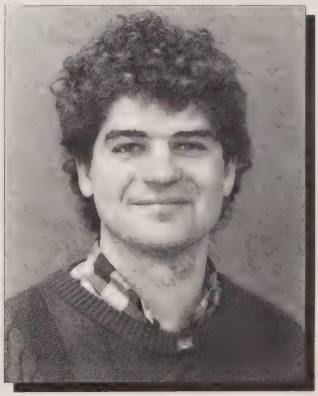
Unless greater maturity is instilled into federal/provincial relations, concludes the Council, it is difficult to be optimistic about Canada's ability to cope with the transitions ahead. The costs of a lack of policy coordination, as documented in the Review, must convince governments to rise above their present divisions. If they do not, Canada's options will be limited and unappealing.

A collective effort to control inflation and to fight unemployment would put the Canadian economy on a healthy growth path for the medium term and would also help Canadian society through a vital transition to a policy framework suited to the realities of the 1990s.

New Council members



Ken Woods is the International Vice-President for Canada of the International Brotherhood of Electrical Workers. Born in Guelph, Ontario, he has held, since the early 1960s, numerous positions in the labour movement. He sits as a member of the Construction Industry Advisory Board of Ontario, the Canadian Executive Board – Building and Construction Trades (AFL-CIO) and the Executive Board of the Canadian Federation of Labour (CFL).



Pierre Paquette is Secretary General of the Confederation of National Trades Union (CNTU). He holds a master degree in economy from the University of Montréal and has completed studies at the doctoral level at McGill University. He was President of the Conseil central de Montréal of the CNTU. He also taught economy at Maisonneuve College, he was lecturer at McGill University from 1984 to 1985, and has been at the University of Montréal since 1988.

Two steps forward

How well the Canadian economy will fare in the era of high technology depends critically on our capacity to "work smarter."

Working smarter demands two things: a capacity to innovate in our technological infrastructure and, at the same time, a willingness to invest with the same degree of creativity and vigour (if not more) in human-resource development.

These twin goals are the "two steps forward" that all Canadians – workers, businesses, labour unions, and governments – must take if they are to have any hope of meeting the challenges of increasingly stiff competition on national and world markets, both today and tomorrow.

In a publication appropriately titled *Two Steps Forward*, two research directors at the Economic Council of Canada, Gordon Betcherman and Keith Newton, joined forces with writer Joanne Godin to illustrate from a series of case studies how a powerful synergy can develop between a well-prepared work force and the latest technology, a synergy that can allow Canadian firms to go head-to-head with their competitors.

The researchers begin by noting that global economic and technological realities have changed dramatically. While pure technological advantage is certainly important, it is a fleeting, transitory phenomenon.

Human resources

Access to technological innovation, therefore, must be complemented by a management style that is sensitive to the role of human resources and the need for professional development. This new emphasis on human resources should not simply be a reactive strategy to offset some of the costs of progress. It must explicitly embrace a range of policies and practices designed to enhance the skills, adaptability, motivation, and performance of workers.

By equipping workers to cope with adjustment to change, this approach minimizes both personal and organizational costs and, in addition, ensures the fullest exploitation of the potential of new technologies.

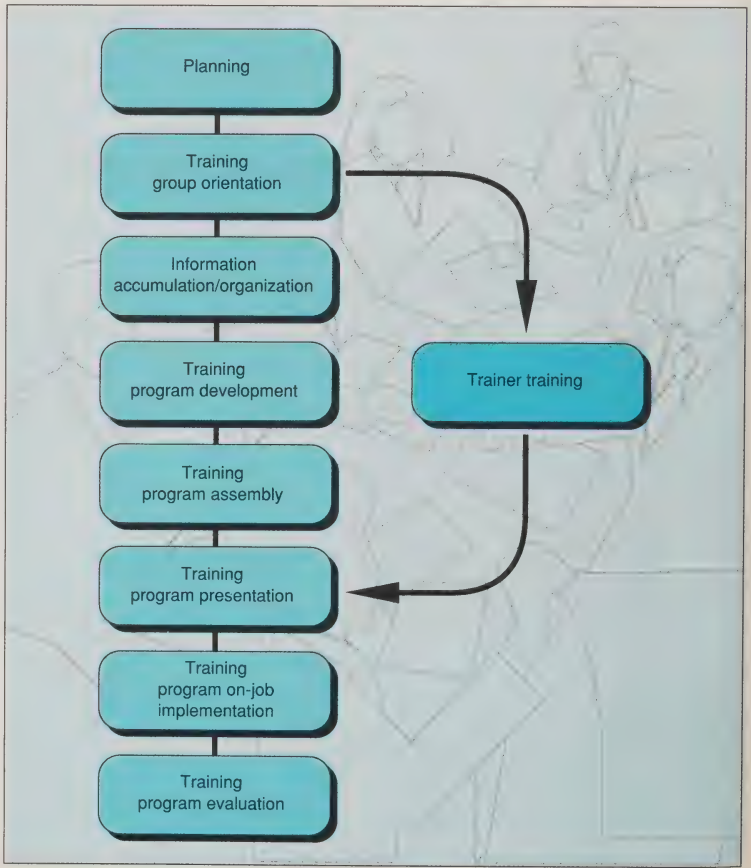
Because of demographic developments, the pursuit of this "innovation synergy" will prove to be even more important in the coming years. As the population ages and the labour force grows more and more slowly, Canadians will be increasingly forced to seek innovative ways to realize the potential of their human capital.

The Canadian experience in this area is somewhat contradictory. It gives cause for both optimism and concern. The case studies conducted indicate that Canadians *can* exercise the foresight, judgment, and good will needed to successfully exploit new technologies in innovative work settings manned by a well-motivated and highly skilled work force. At the same time, it is equally apparent that the processes of technological and organizational innovation, as well as human-resource development, constitute a complex and continuing challenge. "Change is uneven, disruptive, costly, but nonetheless, unceasing," state the authors. "People and organizations, no less than machinery and equipment, need constant care and upgrading."

No miracle cure

The work of the researchers left it clear that there is no miracle cure. While they succeeded in identifying some key ingredients to success and some guiding principles, they stress that they found no ready-made blueprints or instant answers.

People and organizations are unique. They do not come with a detailed set of instructions for installation and servicing. Given the human dimension of the



innovation process, there is rarely a predetermined recipe for success.

The authors find it regrettable that in too many enterprises there is still a relatively greater emphasis on the husbanding of financial and physical resources than on human and institutional resources.

While there are many fine examples of Canadian successes with an integrated approach to the management of workplace innovation, the authors found no firm that was exemplary in itself.

In some enterprises, innovation design was purely technical, with no attention paid to implications for job content. In certain cases, workers found out about technological change only when new equipment arrived at the plant door. The authors note instances where joint decision making really involved management telling the workers what it intended to do. In other cases, fundamental disagreements between the parties could not be resolved. Finally, some firms simply excluded labour unions from the planning process for high-tech production as a matter of policy.

Some objectives

Those case studies where firms enjoyed at least some success point to a number of promising approaches that organizations would do well to observe, say the authors. They mention the following as objectives:

– planning both the technical and social aspects of change in advance;
– developing job designs that incorporate human discretion, responsibility, and skill;
– retraining existing employees so they can be part of the future;
– adapting technologies to expand opportunities for the disabled;
– sharing the added prosperity brought about by technological change; and
– committing themselves to the concept of "involvement" in which all stakeholders have the opportunity to influence the innovation process.

The authors realize that, in many respects, approaches such as these run counter to traditional ways of doing things in Canadian industry.

The importance of communications

Communication plays a critical role in implementing technological and organizational change in the workplace.

Open communication between workers, their unions, and management, and among all levels of an organization can help avoid technological pitfalls and lead to enhanced productivity and job enrichment. According to the authors, a strong union and a strong management team both benefit when common goals are agreed upon and problems are dealt with openly.

In the end, there is a significant degree of complementarity between workers' needs and management goals. "All can win," state the authors.

Employee participation is essential, they believe, to the design of work systems that "fit," and to the goal of increasing workers' accountability and independence in their jobs.

The cases show that virtually all workers can be trained and retrained in the new skills demanded by technological change. High-tech jobs can be made more challenging and interesting for employees, and can sometimes result in better-paying, higher-status positions.

The "socio-technical" approach to organizational design, which aims at planning a work environment that gets the best out of new, integrated computer systems and a new work force, demands careful planning and extensive consultation with employees.

The popular image of the high-tech sector may be inaccurate. The reality is that this industry runs on its people. "Human skills – creativity and knowledge – are behind all the frontier hardware and software, so high-tech firms face a powerful human-resource imperative."

The challenge is all the greater because the sector is intrinsically an unstable one. Products have a very short life cycle, firms come and go, and risk-taking never stops.

In the end, conclude the researchers, Canadian industry faces a choice about how it will operate in the emerging high-technology world. It can pursue the traditional logic of automation – essentially, the mechanical substitution of technology for people – without considering organizational or social implications. Or it can adopt a broader view of new technology in order to invite workers into the process of technological innovation.



We must learn to rely as much on human resources as on new technology.

The deficit virus

Council Chairman, Judith Maxwell, spoke recently on the effect of the deficit on the Canadian economy to the members of the Edmonton Chamber of Commerce. Following is an abbreviated version of that speech.

This is a troubling time for Canadians. We face a period when Confederation must be rethought against a backdrop of regional tension and unprecedented pressures from our aboriginal peoples. The outbreak of hostility in the Middle East creates uncertainty about world military and energy security. Doubts are being expressed about Canada's ability to remain competitive in an increasingly aggressive global marketplace. And, last but by no means least, we may be teetering on the brink of recession. Against this broad canvas, we must discuss the federal debt and deficit.

In my view, the deficit is a bit like a computer virus. Once a part of Canadian society, the effects of the deficit proliferate exponentially, impinging one way or another on nearly all of the issues I mentioned a moment ago.

The nature of the problem

The basic problem is that governments in Canada are spending more than they raise through taxation. The federal government in particular is borrowing to pay interest on the public debt, and, in the process, is pre-empting savings that would otherwise be financing investments that would generate income for future generations of Canadians. In the process, we have become more dependent than ever on borrowing from abroad. And we have left too much of the burden for controlling inflation to tight money.

Note that there has already been a considerable retrenchment in the federal finances. Ottawa has been running an operating surplus since 1985, meaning that total revenues have been more than enough to pay for program commitments. It is the interest on the stock of debt outstanding that accounts for this year's deficit of roughly $25 billion (on a national accounts basis). In short, Ottawa is borrowing to pay interest on its debt. I used to say that we were borrowing to buy the groceries. Now, it is fair to say that we are borrowing to pay the interest on the bill for last year's groceries. This is the virus that plagues us.

In my view, the virus is deeply rooted, politically and economically. Canadians want their federal government to provide a vast array of services – transfers to individuals and provinces, subsidies for agricultural support, transportation systems and energy projects, cultural preservation, training, justice and public security, and so on. At the same time, however, Canadians are sending clear signals that they do not want to pay higher taxes and, in some cases, they are fed up with current tax levels.

There may be a majority of Canadians who wish to reduce the deficit, but there is no clear majority in favour of any of the traditional options of cutting spending or raising taxes.

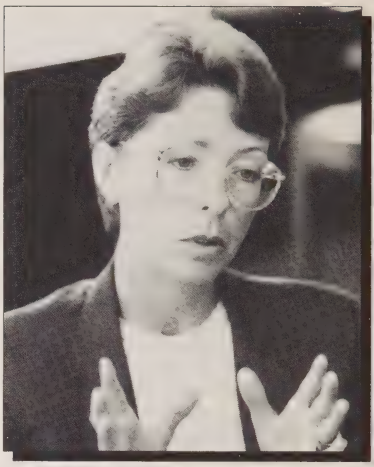
In fact, the spending cuts outlined in recent budgets have probably aggravated political tension in this country. The whole tenor of relations with the provinces has changed, for example. Cutbacks in transfer payments have drawn bitter criticism from many provincial ministers, who believe their province does not get its fair share of federal largesse. Also, scaling down federal projects has actually left some communities feeling betrayed by their national government.

There is in fact a large gap between what citizens want and what they are prepared to pay for. That is the political dimension of the virus. The economic dimension is just as intractable. Efforts to reduce the deficit have been especially handicapped by high interest rates.

The obstacles

The level of "real" interest rates, on average, has been far higher through the 1980s than in either of the two previous decades. "Real" rates in Canada in the first half of 1990 averaged about 10 per cent. This is exceptionally high by historical standards – the average was very low in the 1970s and was about 6 per cent in the 1980s.

Our sense at the Economic Council of Canada is that we should anticipate relatively high real interest rates to continue through the 1990s. This is predicated on central banks' continued determination to resist inflation, the strong capital needs connected with



Judith Maxwell

Europe 1992 and the reforms in Eastern Europe and the Soviet Union, not to mention requirements in other parts of the world, including the developing countries.

You will recall that last February's federal budget anticipated a decline in interest rates that would begin this year and gain momentum in 1991. Reading between the lines, it appears that the underlying view was that real interest rates in the next few years would average 3.5 per cent compared to the 6 per cent that prevailed through the 1980s. In our projections at the Council, we are looking for real rates to fluctuate in the 5-per-cent range in the next few years. We expect nominal short-term interest rates to continue the decline that began last spring and to reach the 10-per-cent range by 1992. Then as inflation decelerates, interest rates will fall further. While this is definitely an improvement on the environment we have faced in the past year, it is an interest rate scenario which will make deficit reduction exceedingly difficult over the next few years.

The progress to date

The payoff from the restraint embodied in the April 1989 and February 1990 budgets shows up in two ways. First, the federal government's fiscal position is improved, as you would expect – the debt-to-GDP ratio is expected to decline

significantly by 1995 if a scenario of recession can be avoided. One key reason for the improvement is that the annual cost of servicing the public debt falls by $10 billion. This reflects two forces. First, there is a slower accumulation of debt, and, second, interest rates are about half a percentage point lower because the government is borrowing and spending less.

The other payoff is that overall economic performance is improved in the long term. Because interest rates and inflation are lower than in the absence of restraint, investment and productivity should be higher. And this builds the foundation for higher real incomes of Canadians in the longer term. This is true despite the fact that restraint slows the economy in the first year or so, so that output and employment are slightly lower in the period 1990-95 than they would have been in the absence of the restraint in these two budgets.

This analysis illustrates the complex feedback effects in the economy, notably the interaction between monetary and fiscal policies. Many of the positive effects occur because restraint reduces the burden on monetary policy by slowing spending. This in turn creates a more favourable financial environment for investment. In other words, deficit reduction is favourable to a sustained decline in interest rates.

But this interaction is a two-edged sword. It cuts both ways. A severe recession would seriously undermine the fiscal plan, eliminating nearly all the progress that was made in the past two budgets. It would create the environment for a proliferation of the deficit virus and would put the federal government in the terrible dilemma of having to raise taxes or cut spending in the middle of a recession.

In summary, Ottawa is under pressure from all directions. The incipient tax revolt restricts the government's scope for action on the revenue side. Spending cuts in specific areas tend to put more political stress on the social fabric of the country.

But, without deficit reduction, this backlog of debt will erode the capacity of the government to deliver the basic services that people want and need. In short, we have to retrench in order to make progress on reducing the debt burden. The reward at the end of the process is that, once the debt-to-GDP ratio does start to decline, we enter a virtuous circle where interest rates in Canada can drop to levels closer to historical norms. This, in turn, speeds up the progress in getting the federal finances in order.

When faced with excessive debt, the private sector has options that are somewhat more clear-cut than those available to government. Companies can sell off assets, they can reorganize so as to curtail their less profitable operations, or they can go out of business.

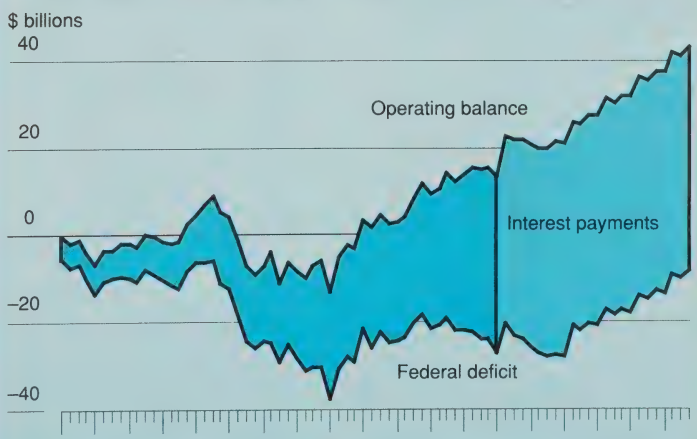
The federal government has sold off some assets, and it has done some reorganization. But it is not in a position, in these troubled times, to undertake drastic and unilateral fiscal surgery. Any changes to major programs such as transfers to provinces or to individuals will require a lot of analysis as well as careful consultations with all of the parties involved. In effect, we are talking about a redefinition of what citizens want most in the way of public services, and how much they are willing to pay for those services.

In the Council's view, Canada has reached a stage where we need to find new ways of making decisions on economic policy issues. The Council has been developing some options, which should help governments to cope more effectively with this deficit virus while making progress on other important economic goals like employment and inflation.

In closing, let me say that there are no quick and easy solutions to the deficit problem. Some progress has been made, but a recession could wipe that out and cause the deficit virus to flare up again. Nor do I think that we can expect declining interest rates to be enough to solve the problem for us.

Yet, for the sake of future generations, we have to make a determined effort to climb over this mountain of debt. It seems inevitable that the federal government will be forced to curb existing commitments even further just to meet the new claims on the public purse in the next few years. This will be tough medicine to take, but we must bear in mind that it will eventually bring genuine longer-term payoffs for all Canadians.

Federal Deficit and Operating Balance, 1977-95



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PUBLICATIONS

Twenty-Seventh Annual Review

Transitions for the 90s – Twenty-Seventh Annual Review (EC21-1/1990E; $11.95 in Canada; US$14.35 outside Canada).

This year's Annual Review presents a medium-term outlook which falls short of what the Economic Council of Canada considers a desirable performance with respect to inflation, unemployment, and the federal fiscal position. The Review identifies the rigidities in labour markets and the problem of regional economic specialization as two key factors that explain the high level of structural unemployment in Canada.

The Council identifies two transitions that must be made for the 1990s: gearing up for new global realities, which will inevitably cause major changes in the composition of employment, and development of a new set of institutional relationships which will enable Canadians to control inflation with less pain.

Annual Report

The Economic Council's *Annual Report* for 1989-90 is now available. It includes a message from Chairman Judith Maxwell, as well as details on Council activities and research projects. One article describes the research process at the Council. For a free copy, write to the Publications Division (address below).

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SPECIAL FEATURE
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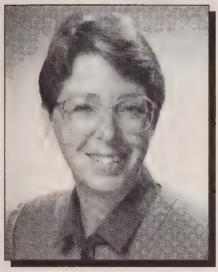
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Some encouraging signs



Judith Maxwell

When the Council launched its study of immigration two years ago, we felt it was time to update our knowledge of the economic and social effects of immigration to take account of the potential impact of an aging population. We strongly suspected, after looking at work done in other countries, that the economic impacts of immigration would turn out to be modest.

We were also convinced that the changing mix of immigrants raised important issues to do with social harmony. We noted that the United Kingdom found that open-ended immigration from the Commonwealth without successful integration of the newcomers could lead to social conflict. And we knew that Canada's history with respect to the treatment of visible minorities was not all that reassuring – for many years they simply were not accepted as immigrants.

In fact, the research reported in the Council Statement *New Faces in the Crowd*, shows that the economic effects of immigration on the host population of Canadians are small, but they are positive. The results on the social side provide some favourable surprises.

We found, for example, that members of visible minorities who immigrate to Canada and receive most of their education here earn the same levels of income over time as similarly qualified people of European origin in the same age group who were born here in Canada. On the other hand, newcomers whether from a visible minority or not, who receive their education abroad experience a period when incomes are below those of Canadian-born in the same age group, but the newcomers do eventually catch up. Thus we find strong evidence that immigrants are successful whatever their origin: they do well economically and they appear to integrate well.

There is also definite evidence of increasing tolerance for people from different ethnic origins over the past 15 years – the very period when the proportion of visible minorities in Canada has been rising. This is especially remarkable when you think that the past 15 years have not been a time of great prosperity for most Canadians. Real wages have not increased, on average, and there have been relatively high rates of unemployment throughout the period.

While the message is generally good news, the Council Statement approaches the policy choices with some caution because the social results do provide some warning signals. Tolerance is likely to be lower in communities experiencing economic hardship in the form of high unemployment, or in communities where the proportion of visible minorities is rising quickly.

Thus, the Council argues that immigration levels should rise, but slowly, that immigrants' success in integrating should be reviewed every five years, and that research on social issues, particularly on the reaction of minority groups, should be done soon and then repeated regularly. The Council also insists that a major commitment to combat racism is essential. Such a commitment cannot be legislated, it has to reflect the political will of all the parties to the process – governments and citizens.

We have identified a genuine Canadian asset – social tolerance. We must make sure that we preserve and enhance it.

New faces in the crowd

In recent years, immigration has been moving to the centre stage of public debate. One thing is certain: the subject is highly controversial.

It is also extremely complex. Despite the multitude of factors involved, it is often difficult to identify exactly what those factors are. Frank and open discussion, especially about visible minorities, often seems inhibited by the fear of being accused of racism.

Somewhat like a curved mirror, the image of immigration is perceived differently by different people. Some see a long list of advantages, ranging from economic to cultural and humanitarian. They point to the role immigrants have played in the country's development and suggest that immigration is one way to counter Canada's declining birth rate and aging population, two trends with potentially enormous consequences for social and health-care costs.

Other Canadians, looking into the same mirror, are worried that immigration will lead to the erosion of Canadian traditions and values. They have difficulty seeing the claimed advantages of cultural diversity and multiculturalism. Others are convinced that immigrants steal jobs from Canadians or that they lower wages and working conditions. They are also uneasy about the rising short-term costs of immigration at a time when government deficits are becoming alarmingly large.

To complete the picture, it should be recalled that during the 1980s Canada accepted 1,250,000 immigrants, many of whom settled in the country's major cities. About one third were of European origin, while the majority hailed from Asia, Africa, Latin America, and the Caribbean. The number of people claiming refugee status has also grown steadily.

It is against this backdrop that the Economic Council undertook to examine the impacts of immigration on Canada.



A gradual increase in immigration

In its Statement entitled *New Faces in the Crowd*, in which the primary economic, social, political, and humanitarian factors in the immigration debate are analysed, the Council concludes that the economic consequences of immigration are positive but quite small. On the more specific question of unemployment, the Council asserts that there is no correlation between immigration levels (or, in fact, even the size of the country's population) and unemployment levels. The research findings are very clear on this point. As long as immigration levels – whether they be high or low – are stable, immigration does not create unemployment.

Consequently, says the Council, it is essentially on humanitarian and social grounds that Canada should decide to opt for increased immigration. This leads to its first and most important recommendation: that the immigration rate be raised gradually to 1 per cent of Canada's population by the year 2015.

The Council stresses, however, that the increase should be gradual and carefully implemented in order not to aggravate social friction; since, despite an apparent increase in racial tolerance of visible minorities, the potential for such a flare-up persists in Canadian society. In addition, a too-rapid increase in immigration at a time when unemployment is high could provoke a backlash against immigrants in general, because of a mistaken perception that immigrants take jobs away from Canadians.

Although it is very difficult to measure the benefits of ethnic and cultural diversity, the Council comes out in favour of such diversity, judging that it helps make Canada a more interesting and exciting society. From the humanitarian point of view, immigration makes it possible for people to escape from sometimes desperate economic, social, and political straits, or at least to effect substantial improvement in their living standards and to vastly improve the future prospects of their children.

Moreover, when economies of scale and future tax and dependency effects are taken into consideration, almost all immigrants who arrive in Canada create a slight economic gain for the host community, relative to the cost involved in accepting them.

"It would be hard not to recommend an increase," states the Council's report, "when immigrants can gain so much and when Canadians not only do not lose but actually make slight economic gains."

Overall, then, considering all aspects of Canada's current situation, social and humanitarian factors justify making the country more open to immigrants.

One of the Council's conclusions is heartening: research indicates that Canadian's tolerance for immigration has grown in recent years. And tolerance appears to be greatest in areas where immigrants, including visible minorities, are most numerous. That observation seems to confirm the "contact" hypothesis, which suggests that familiarity breeds acceptance and more positive attitudes among the various ethnic groups. These results, says the Council, are most encouraging, although there is still reason for prudence.

As mentioned earlier, immigration will increasingly alter the face of Canadian society, because in contrast to the situation in the early part of this century, new arrivals no longer hail predominantly from Europe, but rather from Asia, Africa, the Caribbean, and Latin America. They are increasingly what are called "visible minorities," and the trend will almost certainly continue.

At the present time, in Canada about one person in 20 is of non-European origin. Even if immigration rates stay the

same, this proportion will reach one in 10 nationally in the next 25 years. The proportion will be higher still in major urban centres like Toronto, and Vancouver where about 20 per cent of residents will be of non-European origin.

The Council also takes pains to dispel a number of myths: that immigration is the solution to our aging population, or a ready-made answer to our declining birth rate, or the cornerstone of economic prosperity.

The economic prosperity enjoyed by a country does not necessarily have anything to do with its demographic size. In other words, there is no proof that a larger population automatically generates higher average per-capita incomes.

So while immigration likely does confer some gross benefits on the Canadian population as a whole (in the form of the efficiency gains from a larger domestic market), these benefits can only be very small when measured in terms of each individual in the host community.

Although immigration clearly played an important role in Canada's earliest years, it is a mistake to think that Canada's survival depended on it. By the time of Confederation, immigration had subsided substantially: the population pump was already primed, and immigration subsequently played only a small part in population growth in eastern Canada. There was a short-lived but large burst of immigration as the West was settled, between 1900 and 1914. Between the two world wars, however, immigration declined once more, making hardly any contribution to demographic growth. Although immigration intensified after the Second World War, it was not nearly as important for total population growth as natural increase. In fact, the history of immigration in Canada is characterized more by several distinct waves than by a sustained inflow.

A target of 1 per cent

As was noted earlier, the Council's first recommendation is to increase immigration gradually above the average levels of the past 25 years, to bring the number of new immigrants to 1 per cent of the population on a gross basis by the year 2015.

While acknowledging that increasing the proportion of visible minorities carries some risk, "human nature being what it is," the Council believes that this risk is minimal provided that two conditions are respected:

– the increases in immigration are gradual; and
– the unemployment rate is not too high when the increases occur.

What does the Council's recommendation mean in terms of actual numbers?

In the past 25 years, gross immigration has averaged 0.6 per cent of the population. The Council suggests a gradual expansion in immigration. In concrete terms, that means 168,000 immigrants in 1991, 174,000 in 1992, 180,000 in 1993, and so on, eventually reaching 340,000 in 2015.

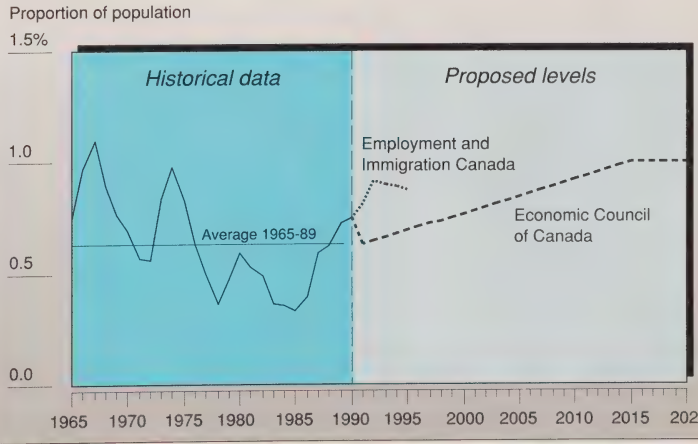
This position differs from recent proposals by Employment and Immigration Canada (EIC). That department proposes that the recent high rates of immigration be maintained until 1992, after which the influx of immigrants will remain stable until 1995. The government has so far not revealed its plans for immigration rates after that date.

The levels recommended by the Council begin lower, but continue climbing right up to 2015.

According to the Council, the EIC plan moves ahead too quickly. It argues that a longer-term perspective is needed. That is why the Council's projections are based on the average level of the past 25 years, not on last year's level. Increases of the magnitude contemplated by EIC would result in too large a 10-year increase over the 1985-95 decade, thereby running the risk of exacerbating social problems and creating temporary increases in unemployment. The risks inherent in the Council's proposal are significantly lower, and the Council also proposes that the situation be reassessed every five years to see how well immigrants are adjusting to Canadian society.

Two other important recommendations by the Council are noteworthy. In accordance with the principle that immigrants and native-born Canadians have mutual responsibilities, the Council proposes that a "moral contract" be instituted between Canadians and the immigrant population, in order to crystallize the mutual obligations of the two groups towards each other. And in order to maintain and reinforce the heartening decline in prejudice in recent years, the Council recommends mounting a major strategic initiative to combat racism and foster tolerance.

Gross Immigration in Canada, 1965-89 (Historical Data) and 1990-2015 (Proposed Levels)



Tolerance: "cautious optimism"

The tolerance of Canadians for immigrants and visible minorities is reasonably high and it is improving, offering grounds for "cautious optimism" about the future.

That is one of the major findings of the Economic Council in its analysis of the social consequences of immigration, the results of which are detailed in its Statement entitled *New Faces in the Crowd*.

As positive as its research results are, however, the report does not conclude that racial prejudice has been reduced to an acceptable level. The Council thus urges Canadians to take greater notice of these issues when developing policy and recommends more direct action to combat prejudice.

The social impact of immigration is, acknowledges the report, much harder to calculate than the economic impact, for obvious reasons.

For this phase of the project, the Council's experts undertook a detailed analysis of the results of most of the major nationwide opinion surveys on public attitudes towards minorities carried out over the past 15 years.

The "contact" hypothesis

One of the most important results to emerge was that respondents from communities with higher proportions of visible minority immigrants were, in fact, more likely to be tolerant of racial or ethnic differences. Proximity and contact with different cultures appear to reduce apprehension and encourage acceptance. The research revealed, for instance, that the proportion of residents of a community who are not themselves members of visible minorities groups and who tolerate interracial marriage, grows as the proportion of visible minorities living in that community increases.

It was also clear, however, that any sudden, rapid growth in the proportion of visible minorities would have a negative impact on attitudes towards them.

Trends over time

Another key finding was that trends over time indicate diminishing levels of prejudice and increasingly positive attitudes as contact with immigrants increases. The only exception was in Quebec, where there was an increasing tendency for francophone respondents to feel that there was "too much immigration" despite an improvement over time in their tolerance of visible minorities. The Council stresses, therefore, that unfavourable attitudes towards increased immigration are not necessarily related to prejudice and indeed do not appear to be so-related in Quebec.

The Council also notes that Quebec's cultural policies have been changing. It recalls that multiculturalism has had a negative press in Quebec because it appeared to undermine Canada's historic cultural duality, and because federal multicultural programs have not always respected Quebec's unique character as a francophone society. In the Council's view, Quebec's approach is more integrationist than assimilationist, despite public perception to the contrary. It is Quebec, after all, that developed the idea of an explicit "moral contract" between immigrants and native-born Canadians (see the article entitled "Towards a moral contract," p. 11).

The Council also commissioned a special experimental study to provide data on discrimination trends over time. The study, which replicated a 1985 examination of employment discrimination in Toronto, had two parts. In the first instance, actors portraying equally qualified blacks and whites applied for the same job within an hour of each other. The second component involved telephone calls to employers in an attempt to obtain job interviews.

The in-person interview part of the 1985 study found whites favoured over blacks for job offers by a 3 to 1 margin. The telephone conversation part showed discrimination against callers with an accent, particularly West Indians and Indo-Pakistanis.

The 1989 replication showed a clear change. There was no discrimination in the in-person job offers. The telephone part of the survey had results similar to the 1985 study, however, with less favourable treatment accorded to accented callers.

These results indicate that prejudice diminishes as the visible minority population grows. It reinforces the Council's broad finding that there is a growing acceptance among Canadians of immigration generally and visible minorities in particular. This leads the Council to issue a "cautiously optimistic" prognosis about the tolerance of Canadians.

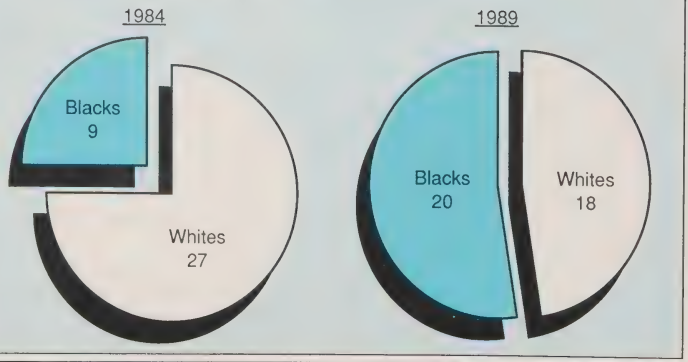
Immigrants

The Council also investigated the economic behaviour of immigrants with the aim of clarifying some of the many common beliefs and opinions about their economic performance.

It should be realized, first of all, that in 1986 approximately 16 per cent of

Job Offers to Blacks and Whites, 1984 and 1989

Field test results in Toronto



Canada's 25 million people were of immigrant origin – roughly the same proportion as since 1951.

Partly because the majority of immigrants came to Canada as young adults (average age, 27.1 years), and partly because many arrived too recently to have yet retired, their average dependency ratio (the proportion of those aged 14 and under and aged 65 and over) is much lower than native-born Canadians. In 1986, the dependency ratio was 28 per cent for immigrants and 50 per cent for native-born. Family size and male-female proportions were similar between immigrants and native-born. One significant difference worth noting is that more immigrants (77.5 per cent) were living in the larger urban areas compared to persons born in Canada (46.5 per cent).

In 1986, the labour force participation rate among immigrants (those in the total population working or looking for work) was just slightly smaller (76.4 per cent) than the Canadian-born rate (77.7 per cent).

Comparing the unemployment experience of immigrants and native-born Canadians shows that, in 1986 once again, immigrants had lower unemployment rates (8.2 per cent) than their Canadian-born counterparts (10.8 per cent). Longitudinal studies show that the unemployment periods experienced by recently arrived immigrants were generally rather short, even during their first year of arrival. Even refugees appeared to find employment relatively quickly.

Following in the footsteps of native Canadians, a growing number of immigrants are opting for self-employment. From 1981 to 1986, the number of self-employed Canadians per thousand jumped from 68 to 90, while immigrant self-employment increased from 79 to 116 per thousand.

Moreover, contrary to popular belief, the proportion of welfare recipients among recent immigrants is smaller (12.5 per cent) than among native-born Canadians (13.8 per cent).

An important issue is how well immigrants perform in terms of their earnings relative to comparably qualified native-born Canadians. It matters too whether visible minority immigrants do worse than either other immigrants, or native-born. The Council finds rather reassuring results, on both counts, based on careful testing in which "endowment" differences between immigrants and native-born are "standardized" and various other factors taken into account. It turns out that there is no systematic discrimination against immigrants, as a whole, nor visible minority immigrants, with respect to income. One important exception, however, is women. Discrimination continues against women, whether immigrants or not.

Last, the report singles out as another important result the fact that, while there is no discrimination against immigrants as such, foreign credentials or education are worth less than Canadian. Immigrants with foreign education and work experience earn less than those whose education and work have been based in Canada. In general, the Council observes, it takes all but the youngest immigrants a number of years to catch up to the earnings of Canadians, although catch up they nearly always do. Immigrants who arrived at an early enough age to obtain all their education and experience in Canada, however, perform as well as native-born Canadians, and this, irrespective of their national origin.

On the subject of language training, the Council points out that immigrants often derive an economic benefit from learning English or French. It thus suggests that immigrants should pay part of the cost of their language training, in the same way that Canadian-born students contribute towards their postsecondary education.

Overall, then, the economic performance of immigrants compares favourably with that of similarly qualified native-born Canadians, indicating that immigrants adapt reasonably quickly and well to the Canadian labour market.

Refugees

The Council also discusses the extraordinary difficulty the federal government is experiencing in controlling and managing the refugee status determination process. Certainly, the number of refugee applicants has risen dramatically in recent years. While it is fully cognizant of the government's budgetary constraints, the Council feels obliged to point out that a do-nothing policy in this area will entail even heavier costs in the future and may make any recommendations about overall immigration levels purely academic. Action must therefore be taken to control the number of refugee claimants and to reduce the backlog of undecided claims.



A large number of immigrants settles in major urban centres.

The economic consequences of immigration

A positive but limited effect

There are a great number of preconceptions, both positive and negative, about the economic consequences of immigration.

While previous studies on the subject have found a small but negative impact of immigration, the Council's research, in contrast, found that the effects on the host population, indeed are positive although small.

The data collected by the Council's research team show, for example, that if the rate of immigration were doubled from its average level of the past two decades, per-capita disposable income would rise more rapidly, though only by a minute percentage a year. After 25 years, in fact, income would be only about 1.4 per cent higher than it would be otherwise. Naturally, an immigration slowdown of the same order would create an equivalently small reduction.

The foregoing is but one example of the statistics cited by the Council in its Statement, *New Faces in the Crowd*, to support its contention that the economic effects of immigration levels are generally small, no matter what aspect is singled out for measurement.

Three factors studied

The Council's economists endeavoured to measure the economic impact of immigration by focusing on three factors:

- economic efficiency;
- tax and dependency levels; and
- unemployment.

Many Canadians take it for granted that because immigration contributes to population growth, it necessarily increases the country's economic prosperity. Testing this notion – rather than simply assuming it is true because of its seeming plausibility – is very difficult. And it is even tougher to make quantitative estimates of what kind of gains might be possible with increased immigration.

The researchers nevertheless proceeded with international comparisons by analysing statistics on some 68 countries for the years 1960-84 to uncover the relationship between population size and economic efficiency. They found a link, but it is a relatively weak one. They confirmed this result by reviewing the potential efficiency gains from scale economies on a sector by sector basis in the Canadian economy.

Their conclusion? Immigration probably benefits present residents of Canada in gross terms by helping to create scale efficiencies in the domestic market, but the benefits are very small when measured per member of the host community.

The theory that immigration enables employers to fill labour market gaps that occur in particular occupations from time to time might appear plausible. Yet it is flawed. For one thing, the positive benefits to businessess and consumers of an uninterrupted "flow" of labour are largely offset by negative effects on existing workers' bargaining power. A second difficulty is that there is no reliable way to detect labour market gaps except on those rare occasions when a shortage is so dire that it is unmistakable, such as the shortage of university professors in the 1960s and 1970s.

Another common perception is that immigrants are economically important, because they are more energetic, productive, innovative, hard-working, and so on. But there is very little reason to think, states the Council's report, that their skills or dynamism, such as they are, will translate into larger incomes for the host population. Attempts to estimate such discrepancies using economic models revealed no evidence that immigrants are permanently worth more than they are paid.

The aging population and the burden of dependence

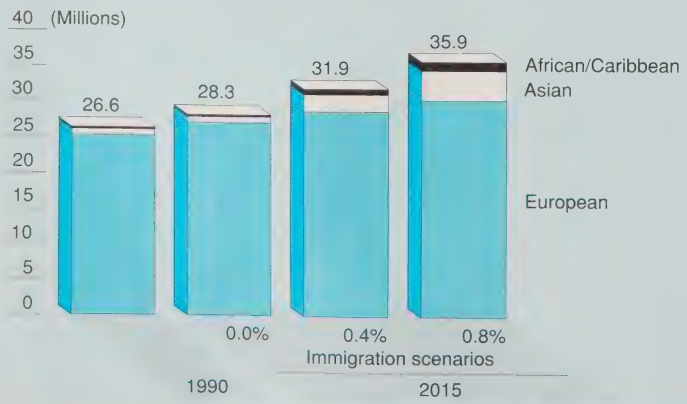
The baby boom has given way to the baby bust, and Canada's population is now growing steadily older. The industrialized economies must one day face up to the problem of an aging population more dependent on social services, coupled with a dearth of workers to finance these needs.

Many people have pointed to immigration as the ideal way to plug this demographic hole in order to finance increased social services.

Yet the Council's research on this issue leads to the conclusion that a higher rate of immigration would cushion the demographic fiscal blow, but only slightly. And these small savings would be further reduced by the costs of necessary services including language training that would have to be provided to the extra immigrants.

To find out how large an effect an aging population and net immigration levels might have on social expenditures, Council researchers constructed a series of scenarios with immigration levels ranging from 0.4 to 0.8 per cent. Doubling the rate of net immigration from 0.4 per cent to 0.8 per cent lowers the

Ethnic Origin of the Canadian Population in 1990 and 2015 (under Three Immigration Scenarios)



annual real per-capita cost of social expenditure 25 years later, in 2015, by $109. This is about one third of one percentage point of a reasonable estimate of per-capita real income in that year.

If immigration is to be increased on the grounds that it will produce fiscal savings, logically the costs involved in the extra immigration must be factored out. In 1985, the federal and provincial governments spent $432 million (about $17 per capita) on immigrant assistance programs. The costs connected with these programs will rise as the number of immigrants increases. This reduces somewhat the already small savings.

In sum, concludes the Council, raising immigration levels would only very slightly diminish the future tax burdens associated with aging.

Employment and unemployment

"Immigrants steal jobs from Canadians." So goes the old argument endlessly repeated by those opposed to any increase in immigration.

However, the Council's investigation on this score came to the conclusion that there is no connection between the two as long as the level of immigration remains stable.

Still, the opposite, more pessimistic notion still finds expression, as evidenced by the fact that governments commonly cut back immigration targets during recessionary periods.

The Council's analysis, both of economic theory and a vast body of international statistics, showed that there was no link between the size of a country's population and its unemployment rate, nor between the speed of labour-force growth and unemployment.

Paradoxically, the findings pointed rather to the reverse causal connection – high unemployment tends to deter many would-be immigrants. In point of fact, periods of heavy immigration are generally accompanied by low unemployment rates.

Population size and economic power

Finally, a series of projections using different immigration levels indicated that, although the size of the country's population might grow as a result of immigration, the relative distribution of population and power among the provinces would be little affected. Council economists developed three scenarios to measure the potential impact of immigration on provincial populations and on Canada's economic power and importance relative to other countries.

Under the first scenario, where no further immigration was allowed, Canada in the year 2015 would have close to the same ethnic mix as today, and total population would be much the same it is now. Real per-capita income would be about one third higher than in 1990. Canada would remain a small economic power vis-à-vis both the United States and the larger Western European nations. The regional distribution of the domestic population would be altered somewhat. Quebec, Manitoba, Saskatchewan, and the Atlantic provinces would experience declines, while Ontario, British Columbia, and Alberta would record slight growth.

Under the second scenario, net immigration is assumed to continue at the pace of the last 20 years levels (approximately 0.4 per cent). Canada's population would grow to about 32 million by 2015; even then, however, the nation would remain a minor power, less populous than the major European democracies. Living standards would rise only slightly more than in the first scenario. Ethnically, there would be changes; from its present level of 96 per cent, the proportion of the population that is of European and aboriginal origin would fall to 90 per cent.

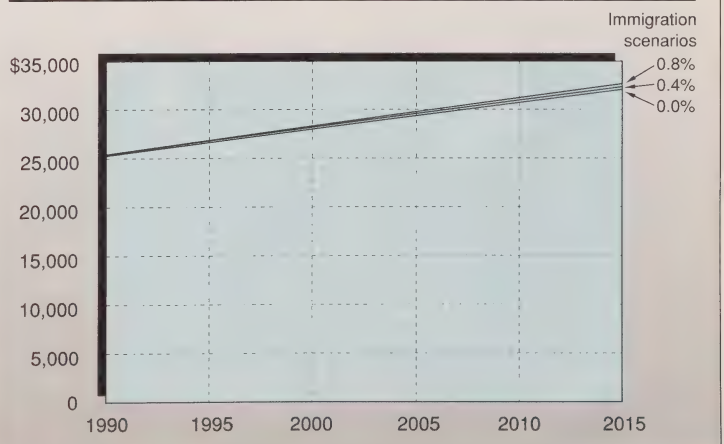
Under the third scenario, which assumes a high immigration rate of 0.8 per cent, Canada would achieve a population of 36 million by 2015, 35 per cent larger than today's. Even with this increase, Canada would still lag behind France, the United Kingdom, and Italy in terms of population. However, in terms of gross domestic product (GDP), Canada might actually surpass Italy and the United Kingdom. Thus the third scenario offers something approaching medium economic power status.

The third scenario would also bring about a dramatic change in the ethnic mix in the provinces and cities. For Toronto, Vancouver, and Montreal, the non-European share of the population would be 29, 26, and 17 per cent, respectively.

Effect on provincial populations

If prevailing patterns of immigration continue, the impact will vary among the

Income per Capita, 1990-2015 (under Three Immigration Scenarios)



provinces as is borne out by the simulations based on the Council's three scenarios.

Newfoundland, New Brunswick, and Prince Edward Island will experience a decline in population relative to the nation as a whole. That decline is more pronounced when the level of immigration rises. Though it fares better than the other Atlantic provinces, Nova Scotia also slips relative to the central and western provinces.

Quebec's proportion of Canada's population is not much affected by immigration; its share drops close to 4 per cent under all scenarios. However, Scenarios 2 and 3 do convert absolute population decline into absolute growth.

Ontario grows under all scenarios in both absolute and relative terms. Scenarios 2 and 3 simply accelerate this process. Even with no further immigration at all, the province will grow by nearly 1 million people by 2015. In Scenario 2, Ontario gains over 2.5 million. In Scenario 3, where a doubling of net immigration rates is hypothesized, the population increases by close to 5 million. As a result, it will have 40 per cent of the national population by 2015, according to this scenario.

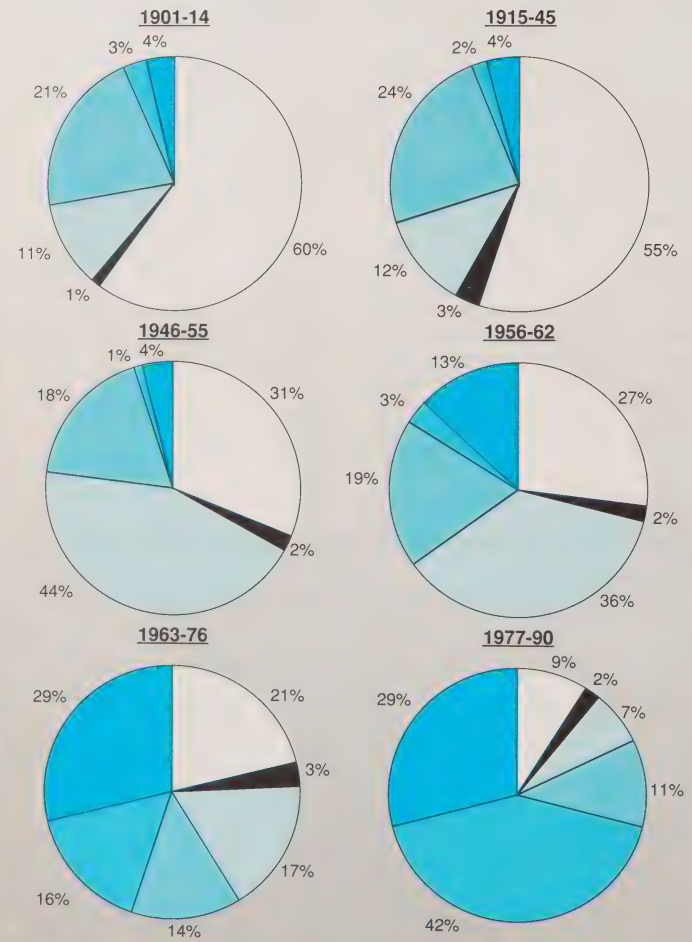
In Manitoba, under Scenario 1, the population is stable or declines slightly. It increases by 13 per cent under Scenario 2, but still falls relative to the rest of the country. In Scenario 3, it rises by 30 per cent and almost retains its present share of the national total.

Saskatchewan's share of the Canadian population remains stable under Scenario 1 but falls under Scenarios 2 and 3, the more so the higher is immigration.

The fortunes of British Columbia and Alberta are similar through the three scenarios. They experience rapid and substantial expansion, both in numbers and ethnic diversity. With no immigration, Alberta grows by 26 per cent, and British Columbia, by 17 per cent between now and 2015. Under Scenario 2, the figures are 38 and 32 per cent, respectively. Under Scenario 3, a rise of 52 per cent gives Alberta a population of nearly 4 million people by 2015; and British Columbia, with a gain of 50 per cent, will have a population of not quite 5 million.

The Council's report sums up by noting that, no matter what immigration scenario is chosen, per-capita living standards in Canada are not greatly affected.

Immigrant Flows, by Region of Origin, Canada, 1901-90



A new "moral contract"

Immigrants and Canadians have mutual obligations towards each other. One way to promote fulfillment of these obligations would be to adopt, Canada-wide, the notion of a "moral contract" between immigrants and native-born Canadians, whereby each party commits itself to respect certain fundamental values of the other. Such a commitment would serve to smooth the integration of immigrants into the country's cultural mosaic while enhancing the benefits that native-born Canadians can derive from the cultural diversity of new arrivals.

Drawing inspiration from the formula developed in Quebec, the Council's Statement entitled *New Faces in the Crowd* specifically calls for the institution of such a "moral contract." The majority of Canadians and immigrants already tacitly subscribe to such a contract, but the Council argues that an explicit statement of this commitment would foster greater mutual understanding and respect.

This contract would be developed by the appropriate governmental agencies in consultation with immigrant groups. Immigrants, for example, would make a commitment to the Canadian Charter of Human Rights and to learning English or French. Native-born Canadians would make a commitment to respect immigrants' culture and language and to help them in their social and economic integration.

Two possible approaches

The Council considered two alternative strategies on the part of the host population towards immigrants – integration and assimilation.

The former approach is aimed at promoting the full participation of immigrants in the host society while allowing them to retain their cultural identity. Assimilation, on the other hand, obliges immigrants to give up their cultural identity as the price for acceptance by the host society.

Integration is, in fact, the official strategy followed by the Canadian government, as embodied in its multiculturalism policy. Yet this approach and the policies that flow from it still arouse a degree of resentment and misunderstanding among a minority of Canadians. It seems to them



that this formula demands too much adjustment on the part of Canadians and too little by immigrants. Some Canadians are beginning to feel that they are expected to be tolerant of immigrants' different ways, but that immigrants are not required, or even expected, to adjust to Canadian ways. The impression is created that Canadian culture is undervalued.

Of course, one way of responding to these signs of resentment would be to adopt an outright assimilationist policy. But even if a sizable segment of public opinion did favour such a change, the Council argues that it is far from certain that it would be in the best interests of the country as a whole.

The Council therefore favours a multiculturalist policy, although it feels that some modest adjustments are needed. Multiculturalism is not aimed at maintaining full cultural systems, but at preserving as much of ethnic cultures as is compatible with Canadian customs. The speaking of heritage languages in the home and at social functions can usually be preserved without any difficulty. However, certain traditional practices of some cultures conflict with Canadian norms and should be "left at the door," such as regressive attitudes towards women and intolerance of religious differences.

Immigrants should be expected to subscribe to fundamental Canadian values and to learn English or French once they settle in the country. Canadians, for their part, should be willing to help immigrants adjust, both individually and through their governments, and to tolerate gladly those cultural differences that do not conflict with fundamental Canadian values.

Combatting prejudice

Despite some evidence of growing tolerance towards ethnic minorities, prejudices has not been eliminated from the Canadian scene, and any rise in the visible minority immigration rate carries the risk of more frequent racial incidents.

Those considerations prompt the Council to recommend that the multiculturalism policy be reinforced through a major strategic initiative to combat racism and foster tolerance. "A comprehensive strategy is needed, involving action by both Canadians and the immigrants themselves," says the Council's report.

Such a strategy, which would be devised jointly by the three levels of government and the private sector, should contain, at a minimum, the following elements:

– an expansion in funding of existing programs designed to fight prejudice at all levels;
– an increase in the current efforts of businesses, unions, communities, and the educational sector to combat racism and promote integration;
– more obligation on the part of immigrants to learn English or French, since this would tend to decrease hostility towards them;
– dissemination of information to defuse hosts' fears that they will lose jobs to immigrants – fears that research has shown to be unfounded;
– avoidance of any sharp increase in the number of immigrants;
– training of immigrants regarding cultural traditions that are inappropriate in Canada, especially with respect to gender equality and attitudes towards authority figures such as police officers, social workers, and public servants in general; and
– extensive race relations training for police forces.

Canadian productivity

Canada is a trading nation. More than 30 per cent of its total output is exported to countries throughout the world. Thus the prospects for improving Canada's standard of living are closely linked to its ability to stand tall in international markets and to sell its products and services.

Since the economic challenge facing Canada is quite clear-cut, it is essential to determine how the country measures up to its major trading partners in terms of competitiveness. To do so, it is necessary to pinpoint the factors that have influenced both the past and present performance of Canadian productivity and costs and to identify the various elements that must be put in place, if Canada is to improve its chances of success on world markets where borders and distances are quickly evaporating through the magic of instantaneous communication networks and high technology.

For some time now, an Economic Council of Canada research team headed by research director Sunder Magun has been wrestling with the complex issue of Canada's competitiveness relative to its major trading partners.

The final consensus statement of this ambitious project, which will present an analysis of the situation and the Council's recommendations in this regard, is scheduled for publication later in the year. In the meantime, some recently completed preliminary studies have brought to light some revealing facts on productivity, cost performance, and Canada's international competitiveness.

Productivity and competitiveness

The researchers have singled out several different aspects of international competitiveness, including labour productivity, total factor productivity (TFP) – which measures the overall productivity of the production process – hourly compensation rates, the level and variability of nominal and real exchange rates, the use of technology, research and development, innovation, capital accumulation, quality of the work force, quality of management, and the role and influence of multinationals in the country's economy. These studies examined the competitiveness position of Canadian industries in various export markets.

The study focusing on Canada's productivity and competitiveness, undertaken by economists Someshwar Rao and Tony Lemprière, arrives at a rather sobering conclusion: total factor productivity growth has declined dramatically in most Canadian industries in the post-1973 period, and the growth of Canadian manufacturing productivity has slowed in recent years relative to all other G-7 member countries. In addition, Canada's cost competitiveness vis-à-vis the United States has declined dramatically since 1986, due in large part to the substantial appreciation of the Canadian dollar relative to the American currency.

In every major industrial sector, with the exception of fishing, output growth declined substantially after 1973, the year in which the first oil-price shock hit. That year marked the start of a long, broad-based decline in Canadian productivity growth and in that of other industrial nations.

The growth of Canadian real output (GDP) steadily declined from 5.4 per cent per year in the 1962-73 period to 2.7 per cent in the 1980-86 period. (See chart Growth in Canadian GDP and its Sources, 1962-86.) The slowdown in total factor productivity (TFP) and in employment accounted entirely for the slowdown in Canadian real output.

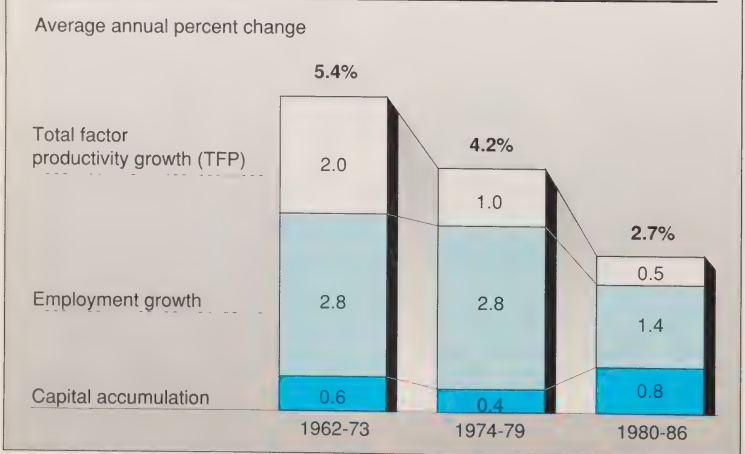
On the other hand, the growth in capital accumulation (capital-labour ratio) has not contributed to the slowdown in output.

Still, in the postwar years, Canada did manage to substantially increase both its aggregate labour productivity and real per-capita income levels relative to the United States. An examination of productivity levels in the manufacturing sector of G-7 countries is most revealing in this regard; it shows clearly that, between 1951 and 1980, Canada succeeded in narrowing by almost 51 points its productivity gap with the United States. At the end of this period, Canadian productivity lagged behind by only about 21 per cent.

However, since 1980 the situation has worsened. Between that year and 1989, the gap widened by 13 percentage points to 34 per cent.

France, Germany, and Italy, countries whose manufacturing productivity levels in 1951 were about half as high as Canada's, had all passed Canada by 1989. In 1951, Japan's manufacturing productivity was only 17.3 per cent that of Canada's. Yet it now stands at 85.4 per cent, a jump of almost 70 percentage points. And, by all indications, the Japanese manufacturing productivity level could surpass Canada's level in the

Growth in Canadian GDP and its Sources, 1962-86



next decade. (See chart Manufacturing Labour Productivity Levels.) The United Kingdom is the only G-7 country whose productivity performance did not significantly improve relative to Canada.

An industry breakdown indicates that the manufacturing-sector productivity gap relative to the United States is pervasive across the vast majority of manufacturing industries.

The picture is not entirely bleak, however. It should be noted that, relative to the United States, Canada has improved its "aggregate" labour productivity and real per-capita income levels. On these two accounts, Canada indices are almost identical to those of the United States (about 95 per cent of U.S. levels) and ranks second on the world scene. Better productivity performance in mining, construction, utilities, transportation, storage, and communication industries was largely responsible for the closing of the aggregate labour productivity gap.

Explaining the productivity slowdown

The researchers' analysis suggests that the slowdown in Canadian manufacturing labour productivity can be attributed mainly to the adverse impact of three factors:

1 The real price of energy has risen substantially.

2 Wages have ceased to rise significantly faster than the prices of other inputs, with the result that the substitution of other inputs for labour has slowed.

3 The value of the Canadian dollar has increased dramatically since 1986, primarily as a result of rising Canadian interest rates, leading to a marked decline in Canada's price competitiveness in U.S. markets. This real appreciation of the exchange rate has had, on average, a small negative influence on Canadian manufacturing productivity, a sharp contrast to the positive response of the U.S., German, and Japanese manufacturing industries to the appreciation in their currency at various times in the last decade.

The analysis implies that the post-1973 period of poor Canadian manufacturing productivity performance relative to the United States, Canada's largest trading partner, was largely due to the following factors:

– a smaller adverse impact of the two energy price shocks on the U.S. productivity;

– a substantial positive rationalization effect on the American productivity, induced by the marked appreciation of the U.S. dollar in the 1980-85 period, and the large increase in the R&D/sales ratios in the U.S. manufacturing industries.

In summary, the Council's researchers indicate that Canadian industry's slower adaptation to the two energy price shocks has created a vicious circle of poor productivity and cost performance, lower capacity utilization, and a real wage slowdown in Canada.

However, the productivity problems now facing Canadians are not entirely the result of structural problems. The Council's researchers offer a somewhat optimistic outlook for productivity growth and real income gains. They base this prognosis on three factors:

1 After correcting for the influence of identifiable factors such as capacity utilization, real energy prices, real wage, real exchange rate, and R&D) there is no break in trend productivity growth in Canada.

2 The substantial gap between Canadian and U.S. manufacturing levels should give an added impetus to Canadian productivity.

3 The expected slowdown in the growth of the source population and labour force and the resulting upward pressure on the price of labour relative to other input prices should induce capital accumulation and improve productivity performance.

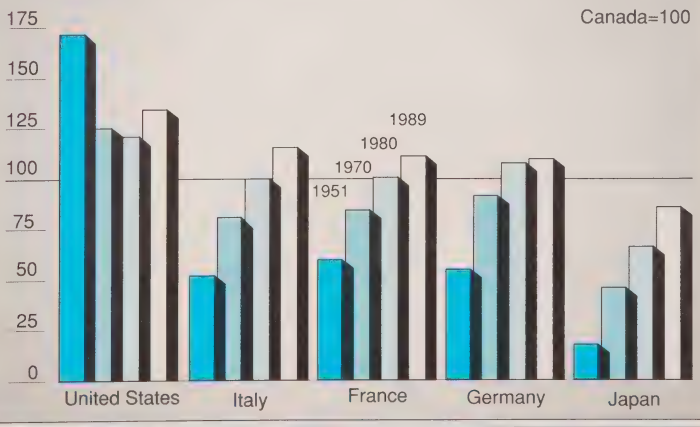
The Council economists also believe that a significant change in the current Canadian fiscal and monetary policy mix would have a positive impact on productivity and competitiveness. Tighter fiscal policies (both federal and provincial), to address budget deficit problems, would simultaneously allow interest rates and the exchange rate to fall and thus improve Canada's cost competitive position. By depressing domestic demand, it would also offset inflationary pressures emanating from the lower exchange rate because of domestic demand.

According to their analysis, Canada's productivity and cost performance can also be improved by policies that:

– facilitate and strengthen the ability to adjust to longer-term structural changes by increasing market flexibility; and

– increase domestic competition by removing national and interprovincial trade and investment barriers.

Manufacturing Labour Productivity Levels, Selected Years, 1951-89



Transitions for the 90s

Council Chairman Judith Maxwell spoke recently to the Treasury Management Association of Canada on the economic challenges facing Canadians in these troubled times. She discussed ways of dealing with these challenges as outlined in the Council's recent 27th Annual Review.

When I stand in front of a business audience these days, I do not need to explain that these are troubled times – that Canada's industrial fabric is under great stress.

The most basic of the stresses on the system is an ever-increasing pressure to compete effectively in the world marketplace. Directly related to that are strains generated by high interest rates, the strong dollar, the federal deficit, rising unemployment and deeply entrenched inflation expectations. Superimposed on all that, we have to rethink Confederation itself.

Without taking the time to describe these problems in any detail, let me set out for you some of the thinking behind the Economic Council's recently released Annual Review entitled *Transitions for the 90s*. In this report we are setting out some practical options for Canadians – options that attack the root causes of our economic woes.

The Council starts from the premise that the status quo is not working. Basic changes have to take place in the way we manage the Canadian economy if we are to find the path to recovery and then avoid getting into this predicament again.

First of all, it is clear that we need appropriate fiscal and monetary policies to correct for the excesses of the past. But the Council is arguing that we must go beyond the traditional technical solutions if we are to create a sustainable recovery.

We believe that the issues that cause us so much concern today – unemployment, inflation and the federal deficit – are actually symptoms of two much more deep-rooted problems. I call them fragmented decision making and an inflexible economy.

Fragmented decision making

First, fragmentation. There is a tendency in this country to compartmentalize problems. We assign the role of inflation fighter to the Bank of Canada, and the role of deficit cutter (at least since 1984) to the Minister of Finance. We designate a government department, Employment and Immigration Canada, to fight unemployment with labour market programs – and so on. Meanwhile, everyone else goes their merry way – provinces, business and labour, as if they had no role to play at all.

One of the main consequences of this attitude is the lack of co-ordination of economic policy among the different jurisdictions.

What is more, if economic policies are going to be truly sensitive to the vast differences in economic structure across Canada, the provinces need to be players in those policies.

An inflexible economy

The second problem is rigidity. This shows, at one level, the inability of the country to adapt efficiently to market changes. Canada is not the country of the quick rebound. The national unemployment rate rose by 4 percentage points in the two most severe recessions in recent times – 1958 and 1982. In both cases, it took six years of sustained growth to get back to the starting line.

Another sign of rigidity is the slow response by business, labour, and government to changes in the economic environment. In 1981-82, for instance, wage settlements did not start to reflect the reality of a recession until 18 months after the unemployment rate had begun to rise. Even now, after manufacturing has been in a steep decline for nearly a year, we see major companies awarding wage settlements that appear to be well in excess of productivity gains.

In short, our true handicaps in Canada are fragmented decision making and an inflexible economy. Both are self-inflicted. They are problems we can solve if we put our minds to it. In fact, we have reached the stage where we cannot afford to let them continue.

A new direction

The Council has no detailed blueprint to overcome these handicaps. But we do have a clear vision of the direction to take. That vision emerges from an examination of how other countries manage their economies.



Judith Maxwell

We note how a number of small, but, in economic terms, successful countries in Europe manage to achieve their economic goals – Switzerland, for example, as well as Austria, Sweden, and Norway.

Over the past 25 years, these countries have managed, for the most part, to contain inflation, keep unemployment rates low, and either balance their budgets or register surpluses. All this and economic growth too.

It would be naive to think that what works there will automatically work here. For one thing, co-operation between labour and management is much less developed in this country than it is in some others. For another, we have strong provinces and wide divergences in regional economic structure.

But it is not our destiny to enter the world marketplace unco-ordinated and fragmented against rivals who have their act together. It is time for labour, management, and government to wake up to the competitive advantage that co-operation brings.

This is a big task, so we have to start with small, feasible steps.

Let's start with the public sector: We have to start building better co-ordination of economic policy between federal and provincial governments.

Here again, there are things we can learn from foreigners – in this case the experience of the member nations of the European Community as they complete their journey to 1992.

The architects of the new Europe have now abandoned the goal of "uniform rules" in favour of "mutual recognition." There is now a recognition that each state is both sovereign and unique. So once they agree on goals, they recognize the capacity of each government to achieve these goals.

Mutual recognition has some obvious relevance for Canada. The federal and provincial governments could agree on goals and basic standards. Once adopted, each jurisdiction could assume responsibility for putting them into effect.

This kind of approach would be particularly useful in the current situation where the federal-provincial dialogue is in limbo, and the nature of the future relationship between Quebec and the rest of Canada is unknown.

In the face of that uncertainty, we still have to occupy the same "economic space." We simply cannot abandon the job of managing the economy in a period when times are hard and our competitors are reaping the rewards of greater integration.

So how do we begin?

One place to begin is with public sector pricing. In the spirit of "mutual recognition," federal and provincial governments should develop guidelines on prices, taxes, user fees, and the rest. This would act directly on the rate of increase in many prices and charges. It would also dampen the expectation that inflation will get worse because even governments have given up.

Business and labour leaders can help this process along by lobbying provincial and federal governments to develop such guidelines.

Why, you might ask, should governments agree? Because they want to see interest rates and the value of the dollar at levels that will permit the economy to recover and will encourage firms to adapt to global realities.

A second place to begin is to build the foundation for a closer partnership between business and labour. We cannot compete in the so-called "high value-added" industries unless we have a talented, creative workforce that is either at work or in training. Putting workers on UI for extended periods of time may keep them from starving, but it does nothing for economic development.

The immediate agenda then for business and labour is training and adjustment. This is not a concession to labour's agenda. This is an agenda for all Canadians – an agenda for economic success in the 1990s and for economic justice for individual workers.

Over the past few years, we have seen a number of path-breaking experiments in sectoral co-operation. It has happened in the steel industry, in the electrical and electronic industry, in the automotive repair and service industry, and in western forestry. In each case, business and labour, usually with financial and logistical support from governments, have struck a bargain to co-operate on training and adjustment. The results are not perfect, but they are impressive. What we must now do is forge broader-based institutions around these experiments so that the benefits of co-operation can be diffused throughout the economy.

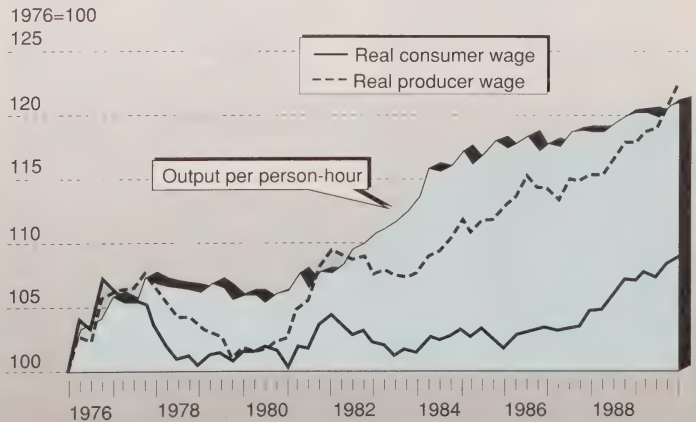
Several provinces and the federal government are now seriously considering creating training and adjustment boards. The plan is to delegate to the business and labour members on these boards the power to design and deliver training. The success of these initiatives will depend critically on the will of business and labour.

In closing, we are in a time of great social and economic stress. Periods like these are painful, but they can be useful if they force people to try new approaches to solving problems. What the Economic Council of Canada is saying in *Transitions for the 90s* is that the status quo in economic policy is not good enough. It is not responsive enough to changing market signals, it is not sensitive to differences between regions, it generates unacceptable choices for Canadians.

Tensions are bound to exist in a large and complex confederation like ours. We have a history of adversarial relationships in collective bargaining and in partisan politics, and we cannot expect to override that history in one fell swoop. But there comes a point where leaders from all sectors focus so much on their battle skills that they lose sight of the overall objective. When that happens, the economy slips into a long-term decline. And, unfortunately, it is the people of Canada who bear the scars.

Thus the time has come to try to build a new set of attitudes and institutions that will help all Canadians to focus on solving problems, rather than angrily casting blame on others.

Real Wages and Output per Person-Hour, Canada, 1976-89



Structural change and adaptation

Every day, many Canadians experience a change in their jobs. Some job changes are voluntary, a return to school or the birth of a child for example; others are involuntary, such as when a firm closes down or lays off employees or when an employee is fired. At the same time workers are constantly finding new jobs. For some it is a new position in a new plant in an expanding business, or for others it is replacing an employee who has left.

This constant process of change in the labour market, with all that it entails in terms of reallocation of workers across and within industries, requires careful evaluation, if policymakers are to develop policies aimed at helping both workers and firms to adapt to an economy which is in a perpetual state of flux.

The challenge of investigating this constantly shifting situation has been taken up by two economists, John Baldwin and Paul Gorecki, in their study *Structural Change and the Adjustment Process*. The study attempts to provide a better picture of the extent, significance, and nature of the short- and long-run changes taking place in the Canadian labour market, particularly in the manufacturing sector. It thus builds upon and extends the results previously published in the Council's *Adjustment Policies for Trade-Sensitive Industries*. A major part of the current project was accomplished through the development of longitudinal databases of firms and workers at Statistics Canada, which co-published the study with the Economic Council of Canada.

While research on patterns of worker and firm mobility and adjustment is not new, there is still a dearth of information on worker turnovers, on the growth and decline of firms, and on the amount of firm entry and exit. This has led to both superficial and quite often incorrect perceptions of the extent and nature of all these changes. This in turn creates the danger that policies will be implemented for problems that are poorly documented or even non-existent, or that expensive solutions will be developed for imagined problems, leaving the real difficulties unresolved.

The extent and nature of change

The study shows that at least 30 per cent of the jobs that existed in 1971 had disappeared by 1981 because of plant closures or cutbacks. Meanwhile, the percentage of jobs gained as a result of plant expansion and opening was substantially higher.

Against this backdrop, Baldwin and Gorecki attempt to estimate the pattern and magnitude of worker and job reallocation, in both the long and the short run, as part of the dynamics of the market economy. Their study tries to answer such questions as:

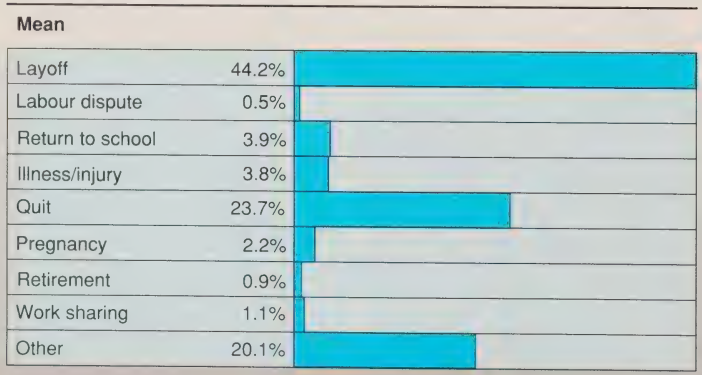
– Have there been shifts in the relative importance of different sectors and industries?
– What is the comparable magnitude of the changes between sectors as opposed to those within the sectors themselves?
– What effects do firm exit and entry rates have on the release and hiring of workers?
– How extensive is the employment expansion and contraction of continuing firms?
– How important is firm size in the process of job gain and job loss?
– How significant are worker separations?
– What is the relationship between firm-related job turnover and worker separations?

The authors have drawn a distinction on the one hand between the growth and decline of jobs associated with employers' demand for labour (job turnover) and on the other hand job separations caused by workers separating from their employers as a result of resignations, returns to school, pregnancy, and other causes.

The study describes the influence of firm entry, exit, growth, and decline on job turnover in the manufacturing sector. This information is generated by building up data from changes at the level of the individual establishment.

Over the period 1970-79, the cumulative effects of entry and exit were large. New manufacturing firms operating in 1979 that had appeared after 1970 either as a result of a merger or of new plant construction accounted for 33 per cent of firms and 29 per cent of employment at the end of the decade. On the other hand, 43 per cent of the firms existing in 1970, accounting at that time for 32 per cent of employment, had disappeared either by mergers or closures by the end of the same period.

Distribution of Reasons for Separation, All Industries, Canada, 1974-86



Worker separation

The authors reveal that the economy-wide number of separations – from all causes – was equal in magnitude to about one half of the work force. For the years 1974-83, the average separation rate in manufacturing was equivalent to 64 per

cent of the work force. The permanent separation rate – that is, the percentage of workers who do not return to the same employer within two years – was much lower, 26 per cent for the economy and 41 per cent for manufacturing. In other words, many layoffs were temporary.

There is substantial variation in those separation rates across sectors. For example, between 1978 and 1981, the annual permanent layoff rate was approximately 7 per cent in the manufacturing sector, 40 per cent in construction, 30 per cent in the primary sector, and only 4 per cent in transportation. Moreover, job separations due to layoffs are typically at least as large as the annual job-loss rate from job turnover calculated for declining and exiting establishments.

The aggregate economy-wide picture is that of substantial change in terms of worker separation and job turnovers. Such change may not be typical of all sectors. Therefore, the study carefully reviews a large number of studies of labour mobility in industries such as footwear, shipbuilding, automobiles, and steel. These confirm the overall picture of mobility.

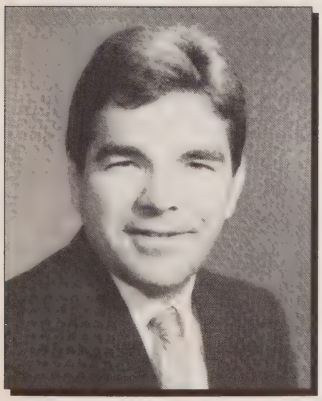
The authors note that the higher incidence of year-to-year net job gain in small manufacturing firms should not mask the fact that the aggregate long-term employment losses and gains from declining and growing large firms account for a greater proportion of total job losses and gains. Obviously, large firms employ many more people than small firms. Thus, while workers in small firms face a greater chance of losing their jobs because of a higher incidence of firm failure, in absolute terms job loss is highest among the large continuing firms that are shedding jobs.

In the decade 1971-81, plant closures accounted for 19 per cent of 1971 employment while plant decline led to a further 12 per cent. On the other hand, during the same period, establishment entry added the equivalent of 19 per cent of 1971 employment, and growth in continuing establishments added another 21 per cent.

Baldwin and Gorecki offer a detailed portrait of labour mobility between industries. One of the conclusions of their research and analysis is that governments should strive for policies designed to facilitate, not hinder, the natural movement of workers who are constantly being released from their jobs.

They also recommend that adjustment policy should be aimed at Canadian industry as a whole, not targeted at specific sectors since it is difficult to isolate a particular cause of change amid this constant sea of change.

New Council members



Adam Lapointe is President of SOCCRENT (Société en commandite de création d'entreprises). A graduate of Laval University in Quebec City, he has been professor of Economics at the Université du Québec at Chicoutimi, and lecturer at Laval University and the Université du Québec at Trois-Rivières. Mr. Lapointe has taken part in the creation of numerous businesses. He is part owner and board member of many Quebec small and medium-sized companies. He has also written many articles and books.



Mary Mogford is President of Mogford Campbell Associates Inc. of Toronto. She is a graduate of the University College of Wales at Swansea. From 1987 to 1989, she was Deputy Treasurer and Deputy Minister of Economics in the government of Ontario. She has held senior positions in the Cabinet Office, the Ministry of Community and Social Services and the Ministry of Natural Resources. She is a member of the Board of Governors of Trent University and the Board of Directors of the Niagara Institute.



Ralph Hedlin is President of Ralph Hedlin Associates. He graduated from the University of Saskatchewan. Mr. Hedlin has been involved in the field of energy economics and political trends. He is also an active member of various committees on economic issues. He has been a consultant, a freelance writer and photographer, and from 1955 to 1958 he was editorial writer for the *Winnipeg Free Press*.

Income and poverty dynamic

Council Deputy Chairman Harvey Lazar spoke recently to the Social Planning and Research Council of British Columbia about the changes that have characterized the economy in recent years. Referring to research begun this year by Council on poverty and social issue , he also described the new dynamics of income and poverty within the Canadian society. Following is an excerpt taken from his speech.

I'd like to say a few words about some new research that the Economic Council has started and that has the potential to shed new light on income dynamics and poverty dynamics, with implications also for the design of income support programs.

Over the last two and one-half years, the Economic Council has been working with Statistics Canada, in conjunction with two provinces, to develop a new database which would enable us to track families and individuals over a five-year period (1982-86). That database has now been completed, and the Council has just begun working on it. The database is drawn from taxation files from the entire country, and social assistance files from the two participating provinces. (Needless to say, all of this work is being carried out in a way which meets both the letter and spirit of the law in respect of such matters as privacy.) We are still in the very early days of our analysis. Nonetheless, I would like to give you a sense of some of the early messages that are emerging from the data. As the research evolves, of course, some to the messages may themselves change.

The extent of change in family composition is my starting point. For purposes of our analysis, we describe as "family change" any one of the following four events: a marriage or the start up of a common law relationship; a marriage dissolution or the end of a common law relationship (including the death of a spouse); the entry of a first child into a family; and the departure of the last child from the family (the empty nest). Between 1982 and 1986, the composition of 30 per cent of Canadian families changed on the basis of this definition.

Second, in addition to all this change in family composition, there appears also to be lots of volatility in family incomes. In analyzing the new database, we ranked all families in the base year of 1982 from bottom to top according to their income, i.e., the lowest 20 per cent of the population in terms of family income were in the lowest quintile, the second lowest 20 per cent in the second quintile, and so on up to the top 20 per cent. Between 1982 and 1986, over one half of Canadian families changed quintiles. Indeed, the figure is 33 per cent in a single year.

Third, it is not labour market events alone which are causing such change. Indeed, changes in family composition are heavily correlated with changes in family income.

The probability of escaping poverty increases dramatically when low income individuals marry. When a single person who is poor marries, there is about 70 per cent probability that the individual will move out of poverty. If a single parent marries the probability of leaving poverty status is around 60 per cent. We do not have enough analysis yet done to comment on the flow of causality. But at least our initial glimpse at the numbers coming out of the database suggest that we have found a pretty good advertisement for marriage.

Equally, marriage dissolution appears to increase the probabilities of going from the state of being non-poor to poor. The probability for married couples of going from poor to non-poor over the 1982 to 1986 period was about 3.7 per cent. But if you were married and became single, the probability was about five times as high. If you were married and became a single parent, the probability was about ten times as high.

You will not be surprised to learn, of course, that the probability of moving into and out of poverty is also highly correlated with the number of earners in the family. When the number of earners rises from one to two, a family has a very high probability of exiting from poverty. Similarly, when the family loses its last earner, there is a high probability of entering poverty.

Let me add a few words about the overall poverty rates that come out of the analysis. From traditional cross-sectional analysis, we know that over the period 1982-86, an average of about 16 per cent of the population was poor each year. If we include all those who were poor at any time over the 1982-86 period, however, we find that close to double that number, i.e., around 28 per cent of the population, was below the low-income cutoffs in at least one of the five years for which we have data. In other words, a far higher proportion of families touch poverty over an extended time period than is suggested by the cross-sectional data. Again, using our same database, we found that approximately 7 per cent of the total population was poor for all five years. Those who were poor for one of the five years we refer to as the "transitional poor." Those who were poor for all five years we refer to as the "persistently poor."

The transitory poor and the persistently poor differ significantly in terms of their family characteristics. The composition of the transitory poor is very similar to that for the population as a whole. But the persistently poor are far more likely to be either single or single parents than the total population.

In providing these few preliminary research results, it is intended only to suggest that we appear to have very powerful new research tool to assist Canadians in understanding important economic and social trends and to help them in making wise decisions about public policies. What lies ahead for this database? In the very short run, we hope to be able to add social assistance data from one additional province to improve the sample from across the country. In the next year or so, it may also be practical to add at least two years of further data to the file (i.e., to extend it to 1988 from its current termination date of 1986).

Finally, if Canadians will be reassessing the effectiveness of their income support programs in the years ahead, it will not only be possible to learn from studying the innovations that have been undertaken provincially over the last few years but also from the new database that has been developed. Understanding the dynamics of income change is fundamental to wise decisions about the development of income support programs. Thus the new Longitudinal Administrative Database can indeed serve as an important tool for policy development in the years ahead.

The economic union of Canada

With the demise of the Meech Lake Accord, the Canadian federation seems beset on all sides. The current division of powers between the central government and the provinces is widely questioned. Some Canadians are now openly discussing new forms of regional association within Confederation, others are calling for massive decentralization or arguing in favour of greater regional autonomy.

As the main theme of its 28th Annual Review, to be published in the fall of 1991, the Economic Council has decided to devote its attention to the evolution of economic and fiscal linkages within the Canadian economic union. Jean-Pierre Voyer will be the director of this project, assisted by a group of researchers at the Council, including the Performance and Outlook group, directed by Ross Preston, as well as a small number of academic researchers on contract. *Au Courant* recently interviewed Mr. Voyer about the new project.

Au Courant: *In what way can economists contribute to this new round of constitutional soul-searching?*

Voyer: There is no doubt that the eventual outcome of the current debate will strongly affect the country's economy and the welfare of its citizens for many years to come. Thus, it would be a mistake to overlook the economic aspects of the question. There have been a number of attempts by economists since the late 1970s to "sum up" the regional gains and losses associated with federalism; unfortunately, the results have usually been contradictory and have had the effect of convincing the public that the advantages and costs involved in a major overhaul of the power structure would be minor.

Au Courant: *And some might conclude that the economic aspects of the debate are not really that important?*

Voyer: Exactly, yet this is far from true. The advantages and disadvantages of specific forms of political organization and power sharing can only become clear in the medium to long term. The impact on the living standards of Canadians may turn out to be critical, once we take the trouble to tally up the advantages and disadvantages in a framework that looks beyond simplistic exercises in economic accounting.

It is also important to place the debate in the context of today's global economy. Canada and its regions are facing the daunting challenge of adapting to world pressures – the theme of the Council's 27th Annual Review. The energy and time absorbed by constitutional debate are diverted from this other important challenge.

Au Courant: *How do you see the role of the Economic Council in this debate?*

Voyer: As an economic research organization with a national mandate, the Council has a duty to provide insight into the economic aspects of this question in order to offer Canadians the information and material they need to make informed decisions.

Au Courant: *What are the objectives of your project?*

Voyer: The theme of the 28th Annual Review is the changing nature of the economic and fiscal links within Canada in light of the new political and economic realities domestically and internationally. We want to take a close look at the current state of the economic union and fiscal federalism in Canada. We must take into account the financial constraints facing the federal government and changes in world trading patterns. The goal will be to examine some of the salient economic aspects of the debate over the future of Canadian federalism and to point out the various advantages and disadvantages of current fiscal arrangements and of some of the proposed alternatives.

Au Courant: *Can you be more specific?*

Voyer: For example, we will investigate the evolution of provincial trade patterns with a view to test the hypothesis that growing global interdependence and stronger North-South trading



Jean-Pierre Voyer

linkages are prompting a shift away from interprovincial trade. We will be examining the extent to which commercial activity in each province is controlled by local interests, residents of other provinces, or foreign interests. We will also be looking at the mobility of workers.

On the fiscal side, we will be examining past trends in government spending, making a survey of expenditures by program category and by level of governments over the past 25 years. We will also be looking at some of the key forces that will influence the growth in spending in the future, and how a redistribution of powers is likely to affect the financial situations of the various levels of governments and the economic welfare of their citizens. We will pay particular attention to intergovernmental transfers in the areas of education and health and social security and to the equalization payments system. Another part of the fiscal theme will be the question of tax harmonization: To what extent does tax structure differ from one province to another, and what are the implications for the economic union?

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PUBLICATIONS

Council Report

New Faces in the Crowd – Economic and Social Impacts of Immigration (EC22-171/1991E; $7.95 in Canada; US$9.55 outside Canada).

The Council's report presents a new and surprising perspective on the economic effects of immigration. Both the benefits and the problems have been greatly exaggerated, says the Council. In particular, per-capita income gains for the host community are very small, and immigrants do not take jobs away from Canadians. The smallness of the economic effects leads the Council to put considerable weight on political, social, and humanitarian considerations in evaluating the right direction for future policy. The social impact of a changing mix of immigration, now that immigrants come increasingly from non-traditional sources (Asia, Africa, and the Caribbean), is extensively analysed. The Council assesses both the greater risks of social friction that this changing mix might entail and the value of the enhanced diversity associated with it. Weighing all four factors – economic, political, social, and humanitarian – the Council opts for a considerable expansion of immigration but argues that it should be phased in very gradually. It offers a recommendation on how to do this, and 10 others aimed at supporting the harmonious integration of immigrants into the Canadian community.

Working Papers

No. 9 "Thinking intergenerationally," by *Ron Hirshhorn.*

No. 10 "Canadian unemployment in restrospect: 1977-87," by *Miles Corak.*

No. 11 "Degradation of environmental capital and national accounting procedures," by *John M. Hartwick.*

No. 12 "Long-term unemployment: The Canadian experience," by *Syed Sajjadur Rahman* and *Surendra Gera.*

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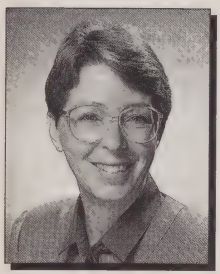
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The appearance of prosperity



Judith Maxwell

The 1980s were perceived by many as a time of relative affluence. It was a time of relatively strong economic growth in most parts of the country. Millions of new jobs were created, housing prices soared in most major cities in Canada. We continued to make progress in fighting poverty (both the incidence and the depth diminished over the decade).

But hidden behind those appearances are some new forms of insecurity and disappointment for Canadians, and quite a few of them are highlighted in this issue of *Au Courant*.

There has been much slower growth in the real incomes of Canadians in the 1980s than was typical of the golden decades of the 1960s and 1970s. Our study of *Employment and the Service Economy* (featured in this issue) found a shift towards greater inequality in earnings from work. Thus we probably have more working poor in this country than we used to have. Certainly, we have many more families with two incomes that find it hard to make ends meet. We also observe a greater dependency on the transfer payment system. Finally, there was a disturbing trend towards more long-term unemployment, indicating that some workers have been marginalized.

I think that these symptoms of hardship explain much of the distemper of our times. They explain why Canadians are so anxious to hold on to status quo – whether that is the social safety net, medicare, or the old industrial structure.

What the Council's work show is that the changes that underlie the signs of hardship are deeply rooted in changes in family structure, new ways of organizing work, and the changing age structure of our population. They are also deeply rooted in the personal choices that Canadians have made in their own lives – how much they invest in their own education, and whether or not their marriage lasts for the long term. People do not often see the decisions on education and marriage as economic decisions, but our research shows that they have major economic consequences for the well-being of all the members of the family.

Against that background, you will find a number of articles in this issue that make the case for changes in the way we organize the economy, and in the way we set our priorities.

First and foremost, it is important for Canadians – workers and managers – to realize that if we wish to live in a high-wage economy, we must earn those high wages through high productivity growth (see my speech on competitiveness). Indeed, we have been falling behind our trading partners on productivity growth and it is that erosion of our capacity to produce efficiently which explains many of the difficulties we have in world competition.

The Council has also learned a great deal from the research on *Employment and the Service Economy*. We have pointed to the need for a substantial improvement in the investment that we make in the education and training of Canadian workers. We have also pointed to the need to reshape the unemployment insurance system so that it is focused on preparing workers for new jobs, rather than paying them not to work.

Thus, rather than clinging to the old way of doing things, we need to establish a new set of objectives for what we want for our people and then find the most efficient way to meet those objectives. These are the kinds of questions we will be posing in our research work on education (see the article on distance education reported here), on health care (see the introduction to the project in Dialogue), and in the new project to be lauched this year on Governments' Impact on Competitiveness (see the description of the project).

All these projects are aimed at providing Canadians with the understanding they need to make well-informed policy choices for the future.

Employment in the service economy

Job polarization

Like the economies of most highly industrialized countries, the Canadian economy is weathering a period of tremendous change, a process whose effects will reverberate for many years to come. And one of the most striking aspects of this phenomenon is something that is simultaneously a cause and a manifestation of these far-reaching changes: the remarkable growth of the service sector.

In the new interdependent economy, the distinctions between goods and services are becoming blurred, and the success of one depends on the efficiency and growth of the other.

As detailed in a research report entitled *Employment in the Service Economy*, a team of researchers from the Economic Council of Canada led by Gordon Betcherman undertook an in-depth look at the massive shift to service-sector employment – its nature and its consequences for Canadians.

Besides the dramatic shift to service-sector employment (a phenomenon that has actually picked up steam over the last decade), the Council's report points to another important development – the clustering of jobs around two poles representing "good" jobs and "bad" jobs. While there has been growth in highly specialized jobs that are well-paid and stable, there is also (and this is the disquieting aspect) a trend towards more non-standard jobs, characterized primarily by their instability, low pay, and lack of protection.

Non-standard jobs may be divided into four major types: part-time, short-term, self-employment, and temporary help.

The largest increase in recent years has been seen in part-time workers. (Part-time work is defined as positions offering less than 30 hours of work a week.)

Workers in non-standard jobs generally earn less than full-time workers occupying permanent positions in the same occupations and industries.

The convergence of goods and services

Over the past few years, it has become evident that the goods sector and the service sector are tending to converge. The Council's report points out that business, financial, communication, and other services increasingly form an integral component of the final product produced by the manufacturing industries.

The services purchased by businesses in the resource and manufacturing sectors, which are subsumed as production "inputs," directly stimulate the growth of the service industries. And services in turn contribute to the competitive edge of resource-based and manufacturing companies by injecting "added value" into their final products.

Human-resource development

The growth of services, combined as it is with the information explosion and the internationalization of business activity, is fuelling an urgent demand for a better-educated and better-skilled work force.

For the Council, there is no question that Canada's future economic welfare depends on its capacity to develop its human resources.

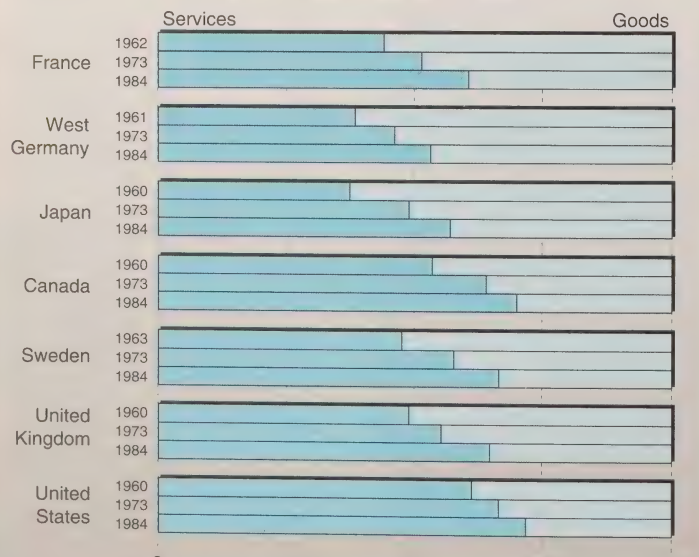
The Council asks why, despite Canada's substantial expenditures on education, the nation does not appear to be getting a better economic return on its investment.

In terms of training, the Canadian private sector lags severely behind other countries. Canadian industry does not invest enough in worker training.

According to the Council, human-resource development objectives should be pursued through a concerted effort involving employers, unions, and the workers themselves, in conjunction with the operation of market forces.

Public policies also need a change of orientation. Most current programs seem inspired by a "damage control" philosophy. Canada's policies emphasize short-term income maintenance instead of "active" strategies aimed at helping workers to improve their long-term employment prospects. That is why the Council recommends a greater policy emphasis on training, mobility, and employment counselling services – all of which can be done, it stresses, without additional outlays.

Goods and Services Sector's Share of Total Employment, Selected OECD Countries, Early 1960s, 1973, and 1984



Skill composition of employment

The gradual shift towards a service-based economy in a working environment where high technology is becoming an inescapable fact of life has led to a general upgrade in the skills required for the vast majority of jobs.

In its research report entitled *Employment in the Service Economy*, the Economic Council acknowledges that this assessment may be controversial. The opinions of observers vary widely: some agree that skill requirements increase as the economy becomes dominated by high-tech services, but others would argue that technological progress tends to undermine the value of work.

While recognizing that large numbers of low-skill jobs are constantly being created in the economy, the Council nevertheless concludes from its research that, overall, there has been an upgrade in the skill composition of employment.

For the economy as a whole, the share of high-skilled occupations in total employment increased by nearly 7 percentage points over the 1971-86 period. The low-skilled group also increased its proportion, although the gain was much smaller. The medium-skilled group, on the other hand, saw its share of total employment decline by over 7 percentage points.

More stringent job requirements

As far as specific vocational preparation is concerned, the Council notes that in 1986, 25 per cent of workers were in jobs requiring more than two years' training, compared with only 21 per cent in 1971. At the same time, the proportion in occupations requiring less than one month of training fell by 1 percentage point.

The same is true of general educational development, where the share of jobs requiring some postsecondary education or the equivalent grew by nearly 3 percentage points over the same period. Jobs requiring less than high school or the equivalent, meanwhile, fell by over 4 percentage points.

Overall, the Council's research shows that a growing number of jobs are demanding higher levels of cognitive complexity, task diversity, and responsibility.

Data on occupational traits also indicate that women are more likely than men to be in low-skill jobs and less likely to be in high-skill ones. In 1986, 17 per cent of women were in jobs requiring less than one month's training, compared with only 13 per cent of men. On the other hand, 29 per cent of men and only 21 per cent of women were in occupations demanding more than two years of training. Gender-based differences in job skills did diminish between 1971 and 1986, however.

Technological change also increases the demand for workers who are specialized in the creation and transmission of information. This represents yet another facet of the change occurring in occupational structure. Between 1971 and 1986, information workers' share of total employment rose from about 45 per cent to over 52 per cent. The service sector generally makes considerably greater use of information workers than the goods sector. However, the importance of information employment varies widely among the various service industries.

More "white-collar" workers

One of the clearest changes revealed by the Council's study of trends in occupational profiles and industrial structure is the growth of "white-collar" and the decline of "blue-collar" occupations.

The report notes that between 1961 and 1986 there was an increase in the white-collar share of the labour force of about 16 percentage points, from about one half of the work force in 1961 to two thirds by 1986.

Between 1971 and 1981, in fact, when total employment increased by nearly 3 million jobs, 80 per cent of the increase was attributable to white-collar occupations. In particular, managerial and administrative, clerical, sales, and service occupations accounted for almost 60 per cent of the total growth.

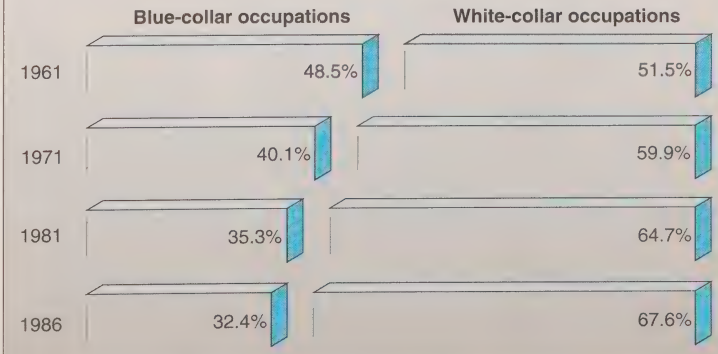
The Council researchers found that this pattern became even more entrenched during the 1980s. Four white-collar groups – managerial and administrative, medical and health, sales, and service occupations – were responsible for almost all of net job creation between 1981 and 1986. The managerial and administrative categories alone accounted for one out of every three new jobs.

Traditionally, white-collar occupations have characterized service-industry employment. In 1986, 86 per cent of white-collar workers were employed in service industries.

Undoubtedly, says the report, one of the major factors underlying the increasing number of white-collar jobs in the goods sector has been technological change.

And it hardly need be added that this phenomenon has profound implications for jobs' education and skill requirements.

Distribution of the Labour Force by Blue- and White-Collar Occupations, Canada, Selected Years



Education: More than ever a priority

Workers with little education or with limited skills are facing an increasingly difficult situation in the emerging labour market. Unfortunately, this threatens to cast a rising number of Canadian families adrift on the seas of economic insecurity.

The message is clear. In the 1990s, workers will have to make doubly sure that their academic and vocational training is as well-rounded as possible, not just to find a well-paying and satisfying job but simply to have a job at all. While education and training per se can offer no guarantees in this regard, workers with inadequate educational backgrounds are bound to face increasingly difficult adjustment problems in the modern world.

As noted in *Employment and the Service Economy*, a research report by the Economic Council, there has always been a connection between education and labour-market success. However, the burgeoning importance of the service sector in the economy, with all that it implies in terms of such factors as technological change, has made this link stronger than ever before.

The Council's research shows that the more highly schooled and the better-trained workers earn higher wages, enjoy greater job security, and have more success in finding a new job when they become unemployed.

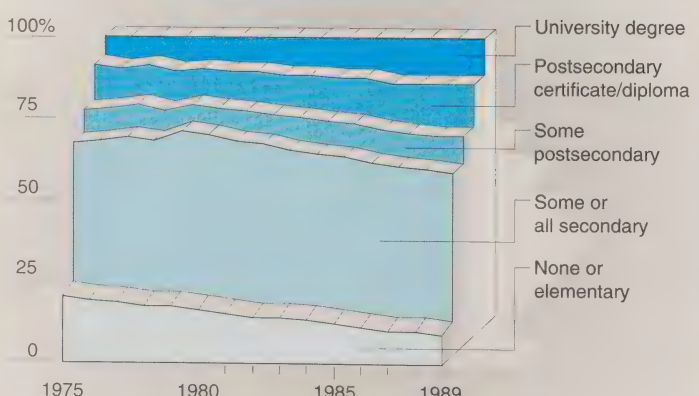
Participation in the labour force

It goes without saying that labour force participation is strongly influenced by educational attainment. Generally, participation rates rise significantly with higher levels of schooling. In 1989, for example, 85 per cent of adults (15 years of age and older) with university degrees were members of the labour force, compared with just 37 per cent of those with less than nine years of schooling.

According to the Council's research, this relationship between labour force participation and educational attainment holds true for all age groups and for men just as much as for women. Indeed, the relationship between educational attainment and work-force participation appears to be strengthening for both men and women. The participation of men with less than nine years of schooling posted a substantial drop over that same period – from 67 to 51 per cent. What's more, the absolute gap in the participation rate of these men and those with the highest level of schooling (postsecondary degree) widened from 24 to 38 percentage points between 1975 and 1989.

Over the same period, the labour-market participation of women increased markedly. In 1975, 44 per cent of the adult female population was in the work force. By 1989, the proportion had climbed to 58 per cent. This trend was evident in virtually all educational-attainment groups – with one exception. The proportion of less-schooled women dropped. As a result, between 1975 and 1989 the absolute difference in participation rates between these women and those with university degrees grew from 41 to 56 percentage points.

Labour Force by Level of Schooling, Canada, 1975-89



Educational attainment and unemployment

As might be expected, the probability of being without a job declines as the level of schooling increases.

Statistics for the year 1989, for instance, show that workers with the most schooling had the lowest unemployment rate. Indeed, the unemployment rate for workers with less than nine years' schooling was three times higher than the rate for university graduates.

Less-schooled, unemployed workers were more numerous in all age groups, but especially among younger workers. For the 15-24 age group, without secondary education, unemployment rate was 23 per cent in 1989 – 10 percentage points higher than the rate for those with secondary schooling and more than 17 percentage points above the rate for university graduates. "The lack of a good educational foundation, then," notes the report, "is particularly serious for young people entering the labour market."

The Council's report also singles out long-term unemployment as another aspect of the labour-market difficulties faced by the poorly educated. Between 1976 and 1989 there was a substantial increase in the overall incidence of long-term joblessness. This increase was particularly dramatic, however, for those with less than nine years of schooling. By 1989, about 11 per cent of those workers remained unemployed for at least a year if they lost their jobs.

The school-to-work transition

Educational attainment also influences early labour-market experiences.

The Council report cites a number of recent studies on the difficulties involved in making the transition to the labour market. In one such survey, 40 per cent of

individuals who did not immediately enter a postsecondary institution after leaving high school had been unemployed at some point since their first job. Employment patterns were particularly unstable for those who had left high school before graduating. On the other hand, employment outcomes were more favourable for young workers who had undertaken some form of job-related education or training after leaving school.

This pattern was even more striking from the perspective of wages; those who had taken some courses or pursued some form of training reported incomes 23 per cent higher than those of young workers who had not had any extra education.

Generally speaking, the early labour-market experiences of postsecondary graduates were positive. In a 1982-87 survey, the unemployment rate was almost 4 per cent for university graduates and 5 per cent for college graduates, five years after their graduations. In contrast, the national unemployment rate for the same age group was 11 per cent.

The same positive pattern emerged for educated workers in terms of earnings. In 1987, college graduates earned an average of $1,000 more than the typical Canadian worker between the ages of 25 and 35. University graduates, for their part, reported employment incomes about $10,000 above the national average for the same age group.

The surveys did indicate significant differences in the earnings of male and female graduates in 1987, however. The average earnings of women with university degrees were 81 per cent of those of men with the same level of schooling. At the college level, the figure was 78 per cent.

Only a minority of students completely terminated their education after graduation. Even among university graduates, only about 40 per cent reported that they did not pursue some education in the two years following graduation.

Higher education also leads to greater job security. The incidence of part-time work was more than twice as frequent among high-school graduates than among university graduates, for example. And 44 per cent of employed high-school graduates expected to be in their current job for no more than six months. Only 29 per cent of university graduates had the same sense of insecurity. Finally, the turnover rate for workers who had completed their postsecondary studies was also significantly lower than the rate for those who had not achieved this level of schooling.

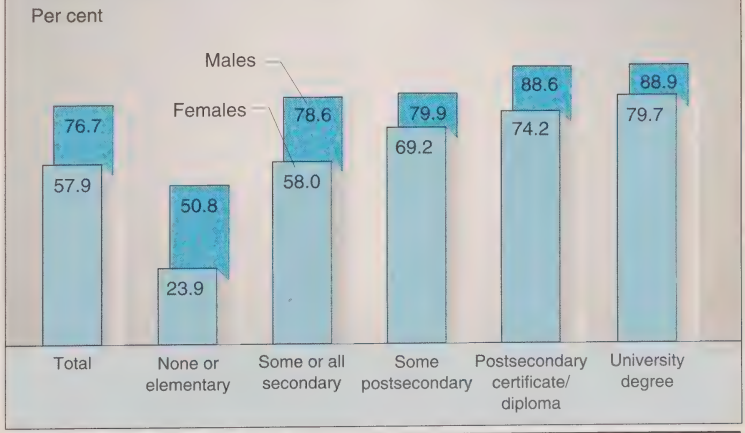
Conclusion

In the face of ever more rigorous international competition, high-cost countries such as Canada will be forced to rely more and more on the excellence of their work force to maintain their competitive advantage in the global marketplace.

While all countries necessarily invest in the full range of factors of production, including capital and technology, the unending quest to achieve high returns on such investments requires a labour force with the right skills and knowledge to exploit their full potential. In short, the performance of national economies is closely linked to the human factor. The direct link between human capital and success in the labour market has actually become stronger over the past 15 years. During that period, the employment and adjustment problems of individuals with less favourable occupational characteristics and job skills appear to have grown worse.

Growth-accounting analyses have shown consistently that improvements in the educational level of a nation's work force lead to increases in its rate of economic growth. Research in this area indicates that the rising educational levels of the Canadian work force have contributed 0.5 to 0.8 percentage points to economic output annually.

Labour Force Participation Rates, by Level of Schooling and Sex, Canada, 1989



Training: Room for improvement

Education quality and the level of schooling are certainly crucial elements of labour market success. But skill formation that takes place outside the formal education system through vocational training also plays a critical role in human-resource development within the work force.

For many workers, training can be a means to obtain and upgrade occupational skills. For instance, it can ease the process of adjusting to the technological and structural changes that have so strongly affected the labour market in recent years. Training can also provide adult workers with a "second chance" to learn the basic skills that are traditionally acquired through formal schooling.

Studies in the United States, which are surveyed in the Council's research report, indicate that employees who receive extra training enjoy significantly higher wage growth than those who do not. As well, evidence suggests that workers who receive on-the-job training experience lower separation rates than other workers.

In short, the growing economic importance of training in the workplace is being increasingly recognized.

A rather poor showing

As mentioned earlier, however, the performance of Canadian firms in the area of training leaves much to be desired. Most do not provide any training at all, with the result that the vast majority of workers receive no employer-sponsored training. And even when some kind of training is available, it is usually offered on an informal basis only.

Looking at private-sector expenditures on training and education relative to total output, Canada ranks behind France, West Germany, Japan, Sweden, the United Kingdom, and the United States. All things being equal, U.S. expenditures in this area are more than double Canada's.

The Economic Council of Canada believes that the overwhelming responsibility for job-related skill formation rests with business and labour.

"Ideally, a strong 'training culture' should be created by forces operating at the firm level," states the report. For example, employers should view skill formation as an essential element of human-resource management; unions, too, should make training a priority; and employees themselves should take the initiative to update existing skills and to acquire new ones.

Government-sponsored training

Federal government expenditures on labour market programs are just slightly below those of the major countries of Western Europe. They still fall well short of the U.S. effort, however. In 1988-89, federal financial involvement represented slightly over 2 per cent of gross domestic product.

The Council's research report notes, however, that Canada's labour market policies have primarily stressed income maintenance, mostly through the unemployment insurance system.

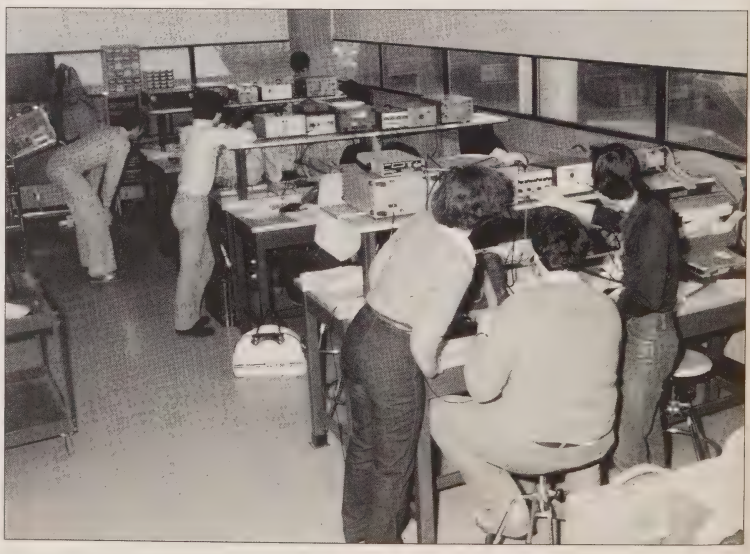
Canada places less emphasis on "active" strategies for training and job creation than countries such as Sweden and Germany. Federal government expenditures specifically on training in 1988-89 represented just under 13 per cent of all federal spending on labour market programs. While this percentage is higher than the figure for Japan, it falls below all other industrialized countries. Japanese industry, on the other hand, is much more active in training than Canadian industry.

The Council realizes that the strong orientation of federal labour policy towards income maintenance has been a subject of lively discussion in recent years. While opinion varies widely, there appears to be a consensus that public policy must become more "active" in the sense of helping workers to improve their long-term employment prospects, particularly through training.

Overall, federal expenditures on training amounted to slightly more than $1.7 billion in the 1989-90 fiscal year. These funds are essentially used for two programs: the Canadian Jobs Strategy (CJS) and Unemployment Insurance (UI), the former accounting for over 85 per cent of the total.

The explicit aim of the CJS is to help those most in need. According to the Council, targeting available funds at these groups may well be the most appropriate way to allocate CJS resources. However, its says, this cannot be considered a human-resource development option for most Canadian workers.

The other major avenue for federal involvement in training is the UI system. Typically, UI claimants must be available for work. Thus they cannot normally



University of Ottawa

Training in the workplace is a major element in the development of human resources.

undertake training on any significant basis. In 1989-90, about 85,000 UI recipients received training under a special UI program, with total expenditures amounting to slightly less than $300 million. In terms of both participants and costs, this represents about 2.5 per cent of the overall program.

The training activities of the provinces, meanwhile, vary considerably. The most comprehensive training programs are found in Ontario and Quebec, the two most populous provinces.

A new approach

The training needs of some segments of the work force appear to be fairly well served at the present time. For example, highly educated, young male professionals employed by large firms obtain a disproportionate share of employer-based training. The same is true of the groups targeted by the Canadian Jobs Strategy.

However, for the majority of the work force there is little, if any, possibility for skill development.

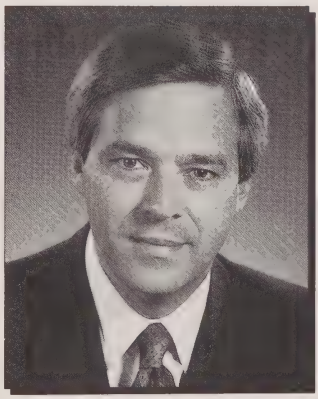
Consequently, the Council recommends that public policy be reoriented to provide more solid support for skill formation and employability. As a long-run goal, it endorses the gradual transformation of the existing unemployment insurance fund into an "employment insurance" fund, which would help workers to develop their skills, enhance their mobility, and obtain occupational counselling. This fund would be financed by both employee/employer contributions and public money.

The Council also recommends that accessibility to training for unemployment insurance recipients be improved. In the same vein, it recommends that the principle of labour market reintegration become the cornerstone of adjustment policy for older Canadians. In this regard, the Council suggests that publicly funded programs put more emphasis on retraining and employment counselling.

New Council members



S. Judith Korbin is Vice-President, Employee Relations, at Canadian Airlines International Ltd. Born in Vancouver, she attended Stanford University and the University of British Columbia. She was a negotiator for the Government of British Columbia Professional Employees Association and a Business Representative for the Canadian Airlines Flight Attendants Association. In 1979, she joined Canadian Pacific Airlines Ltd., where she occupied increasingly responsible positions till her nomination to her present position.



L. Jacques Ménard is Vice-Chairman of the Board of Directors and Chief Executive Officer for the Quebec operations at Burns Fry Ltd. in Montreal. Born in Chicoutimi, he is a graduate of Collège Sainte-Marie, Loyola College, and the University of Western Ontario. Since 1972 he has held increasingly responsible positions with Burns Fry Ltd. During that period he has been on the board of directors of a variety of organizations. He was the Chairman of the Montreal Stock Exchange from 1984 to 1986. Mr. Ménard was Chairman of the Chamber of Commerce of metropolitan Montreal.



Germaine Gibara is President, Structures Automobiles Alcan, a division of Alcan Aluminum Ltd. in Montreal. She has held a number of senior positions at Alcan since 1975. She has attended Dalhousie University, the Institute of Financial Analysts at the University of Virginia, and the Harvard Business School at Harvard University. Ms. Gibara has been active in consultation groups on external trade, with particular interest in automobile and aerospace production.

The impact of productivity growth

The Chairman of the Economic Council of Canada, Judith Maxwell, recently participated in the Third Annual Policy Conference organized by the Canadian Association for Business Economics and the Ottawa Economics Association. The following is an account of her speech, entitled "The Challenge of Global Competition: The Impact on Canadians' Expectations."

"The deterioration in productivity growth in the past two decades explains a lot of the political and social tensions in Canada."

That was one of the main conclusions reached by Mrs. Maxwell in her analysis of Canada's changing economic environment and the implications of that change for all Canadians.

The values that Canadians hold dear are threatened more by slow productivity growth than by many other issues that people worry about – such as the Canada-U.S. Free-Trade Agreement and the Goods and Services Tax.

If Canadians wish to preserve their current high-wage economy, then that economy must become a high-productivity one.

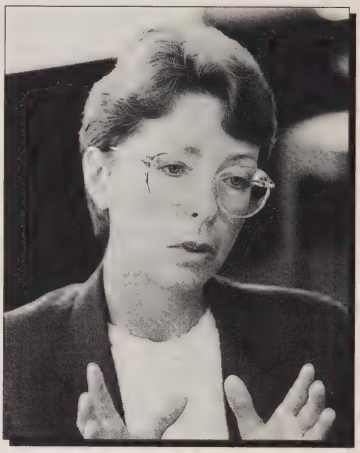
To try to compete with the low-wage economies by paying low wages and accepting low productivity is tantamount to conceding that living standards in Canada are too high and must be reduced. "I do not accept that proposition," Mrs. Maxwell stated.

According to the Council Chairman, governments cannot endow a country with the qualities that generate high productivity growth. These qualities come from the individual skills and commitment of the players in the workplace and in local communities. All governments can do is to try to manage the economic space as efficiently as possible by providing the necessary infrastructure, regulation, and public services. The net cost to society of these efforts must not be so high as to erode the competitiveness of the private sector.

Present and future generations cannot be assured of rising living standards unless Canadians find more-efficient ways to produce goods and services that meet the test of the marketplace. "That will require basic changes in the way we do business in this country," noted the Chairman.

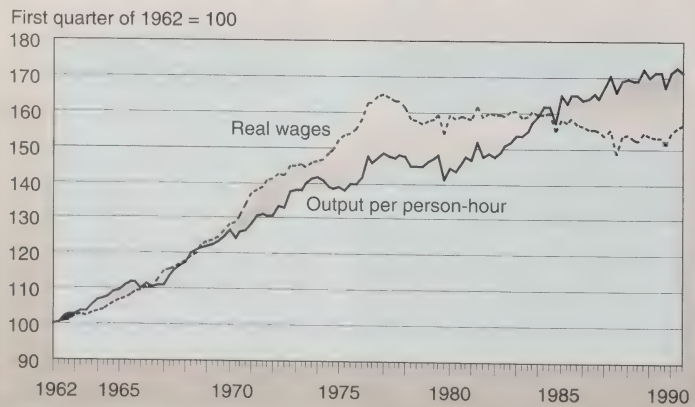
It will, for example, necessitate changes in labour-management relations, in the way workers are trained and prepared to use new technologies, in the type of assistance and encouragement for workplace reentry offered to the unemployed, and in the way communities take charge of their own economic development.

Above all, Mrs. Maxwell emphasized, basic changes will be required in the way the Canadian federation works.



Judith Maxwell

Change in Real Wages and Productivity, Canada, 1962-90



Competitiveness and comparisons

An analysis of trends in certain elements of competitiveness in Canada, the United States, Germany, Japan, and Taiwan reveals that Japan is way ahead in terms of growth in output per hour in manufacturing, followed closely by the United States. Canada and Germany tie for last place.

At the same time, Canada is well ahead of the other countries in terms of hourly compensation, and the gap has steadily widened over the decade. In terms of unit labour costs in manufacturing (expressed in U.S. dollars), on the other hand, Japan and Taiwan have posted the sharpest escalation. Still, their industries have thrived in this environment. Meanwhile, Canada, which stands at about the middle of the pack in this regard, has lost a lot of ground vis-à-vis the United States and Germany.

Data analysis also highlights the contrast in productivity growth between the Canadian and U.S. manufacturing sectors from 1962 to 1989.

While both countries did well on this score in the 1960s, Canada performed better than the United States. Neither

country had much to boast about during the second half of the 1970s, although again Canada outperformed the U.S. The situation changed in the 1980s, however. While the Americans made a clear turnaround, Canadians saw the growth of their productivity start to falter.

Comparison with other European countries paints an equally depressing picture. In terms of manufacturing productivity levels, Germany caught up with and then passed Canada in the 1970s. In the 1980s, France and Italy did the same. Now Japan is rapidly closing the gap.

Roots of the problem

The productivity slowdown began in 1973 with the first OPEC oil-price shock. At the time, Canadians could console themselves with the thought that they were not alone in facing these difficulties. The entire industrialized world was affected. Consequently, there was no compelling reason to look for specifically Canadian causes of the situation.

"But as other countries recovered while we did not, it became clear that we did have unique problems, and that we had better find out what they were."

In the first half of the 1980s, an undervalued Canadian dollar cushioned Canadian industry from the marketplace penalties for inefficiency. With a 70-cent dollar, Canadian industry could compete on price alone without having to worry too much about productivity.

Yet this does not explain what happened when the dollar climbed above 80 cents in 1988. Normally that kind of change triggers improved productivity. This is exactly what happened in the United States and Japan under similar circumstances. But it has not happen in Canada – at least not yet.

The Chairman suspects that at least part of the blame for our faltering productivity growth probably lies with the fact that the Canadian manufacturing sector was slow to embrace new technology. It also hesitated to adopt new approaches to the organization of work itself and to human-resource development. There is also good reason to think that inappropriate industrial policies have perpetuated inefficiency and compromised the capacity of the manufacturing sector to respond to market forces.

The context

An examination of the trends of the past 25 years indicates that economic and social forces have converged to erode the economic security of Canadians. The good life is not as good as it used to be. "In essence, many Canadians – mainly those under 40 – have not been able to achieve their expectations for higher incomes and a better quality of life," noted Mrs. Maxwell. "This is a painful shock for a frontier country built on the implicit promise that each generation would do better than the last."

Statistics show that, except for the 65 and over age group, the slowdown in real income gains has been dramatic. Even though today most young families have two breadwinners, they have, for almost a decade now, been having a hard time getting ahead.

The federal fiscal situation further complicates the picture. Canadians have been deeply and directly affected by efforts to overcome this fiscal crisis. The federal government currently pays out one third of its revenues in debt service, up from about 12 per cent in the early 1970s. Canadians are paying much more in taxes, but are receiving less in terms of services.

And that, said Mrs. Maxwell, is the root of a general sense of disillusionment with governments and a remarkable fear of major policy changes.

The role of government

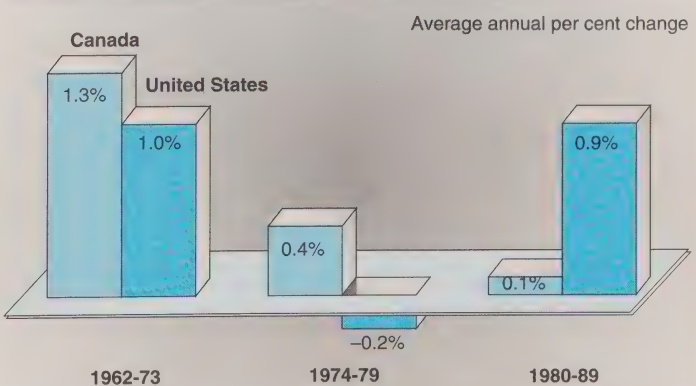
Many people expect their governments to find solutions to the problems that arise as a result of changes in fundamental economic trends. They do not understand, Mrs. Maxwell maintains, that they too must share some of this responsibility through their own actions.

Nor do people understand that governments have little control over the pervasive impacts of global competition and of new technologies. Indeed, governments' efforts to protect Canadian industry from the cold blasts of global competition have not always proven beneficial, at least in the long run. Canadians also do not realize the extent to which the federal government has been truly crippled by its deficit problem.

In the Chairman's view, governments must put their fiscal houses in order and set expectations straight about what they can and cannot do.

In the short to medium run, Mrs. Maxwell concluded, there must be greater coordination and sharing of tasks between the federal and provincial governments and between the Department of Finance and the Bank of Canada. In the longer run, once the basic trust between government, labour, and employers has been repaired, Canadians will be able to count on the tools of social partnership to improve their situation.

Growth in Manufacturing Productivity, 1962-89



Long-term unemployment

When he opens his shop on Monday morning, a florist has a stock of fresh flowers. Assuming no price variation, the most popular varieties of flowers will be the first to be sold during the course of the day. The next morning, therefore, his stock will include a high proportion of less fashionable flowers, which are now also one day older. These will have to compete with a new supply of fresh flowers. The end result? As the week advances, the florist finds himself saddled with stocks of unpopular, rapidly wilting flowers.

As heartless as it may sound, this analogy provides a good illustration of the problem of long-term unemployment in Canada. Unable to find work, for a variety of reasons, workers can see their hopes of escaping from joblessness wither away the longer they languish in unemployment. And the situation is even more difficult for older workers.

Two economists from the Economic Council, Syed Sajjadur Rahman and Surendra Gera, have turned their attention to this phenomenon in order to identify its causes, ascertain its extent, and finally propose some possible approaches for improving the situation. The results of their research are presented in a Council Working Paper entitled "Long-term unemployment: The Canadian experience."

Taking stock

In spite of strong economic growth and job creation during the 1980s, the incidence of long-term unemployment has remained unusually high. Even in 1989, when the unemployment rate had returned to its 1981 level, the proportion of the labour force that had been unemployed for a year or more was one-and-a-half times greater than in 1981. These workers comprised 4.3 per cent of the total number of unemployed workers. The recession of 1981-82 caused a dramatic increase in this percentage, albeit with a lag. It reached a high of 10.1 per cent in 1985, then declined to 6.6 per cent in 1989. Nevertheless, the incidence of long-term unemployment (LTU) remained in the late eighties 1.75 times higher than the levels preceding the recession.

Even though the situation in Canada is less critical than in several other industrialized countries, prolonged periods of unemployment carry considerable social and private costs – reason enough to give this issue special attention. Chronic unemployment "scars" its victims, eroding their work skills, reducing their employment potential, and affecting their morale. The persistence of LTU is also a sign that labour markets are not working efficiently.

The current high proportion of long-term unemployed is all the more disturbing in that it has persisted through a period of economic expansion. Judging from the experience during the last business cycle, LTU increases sharply during a recession but declines very slowly during the expansionary period.

Regional and demographic trends

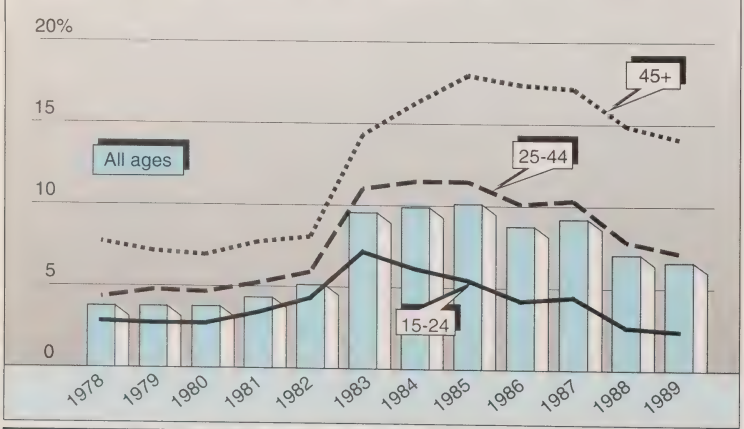
Regional disparity in unemployment rates is also reflected in provincial long-term unemployment patterns. For example, the incidence of long-term unemployment in 1989 was well above the national average in Quebec and British Columbia. The proportion of long-term unemployed was below the average in Ontario and the Prairie provinces, reflecting the relative movements in their unemployment rates. Only the Atlantic provinces bucked this pattern. While their unemployment rates were higher than the national average, the proportion of long-term unemployed in those provinces was generally lower than the average.

Thus regional differences in long-term unemployment accentuate regional employment disparities.

Age, sex, marital status, education, and occupation are all personal attributes influencing an individual's chances of becoming a victim of long-term unemployment. According to the researchers however, the most significant disparities have occurred among the different age groups. Statistical evidence shows clearly that the incidence of long-term unemployment rises with age. In fact, the probability of being trapped by long-term unemployment is three times higher for older workers than for the young. This pattern is again especially evident in Quebec and British Columbia. In the former province, older workers accounted for about 35 per cent of the long-term unemployed in 1989, compared with 25 per cent in 1983. In British Columbia, the corresponding figures were 40 per cent in 1989 and 21 per cent in 1983.

According to the two Council researchers, the dramatic rise in the incidence of long-term unemployment among older workers is a clear indication of significant adjustment problems. The persistence of LTU in this group also suggests that these problems were not resolved by the general economic recovery of 1983-89.

Proportion of Long-Term Unemployment, by Age Group, Canada, 1978-89



Causes of long-term unemployment

The origins of long-term unemployment are closely related to the causes of unemployment in general.

Sudden fluctuations in demand, such as those associated with the recession of the early 1980s, cause an increased inflow to the pool of unemployed workers. Abrupt changes in supply, such as the oil prices shocks of the 1970s, have the same effect.

While most unemployed individuals find jobs quickly as economic conditions improve, a minority get locked into an unemployment trap. A variety of factors may be involved, such as the evolving nature and composition of economic activity, as well as personal characteristics like age, skill level, length of unemployment, employers' hiring preferences, the intensity of the person's job search, and constraints in mobility between different regions and between urban and rural areas.

Inflows into unemployment can be initiated either by the employer or by the workers. Employer-initiated inflows are more likely to occur in recessionary periods, while worker-initiated inflows tend to occur in expansionary periods. Although older workers are usually the last to lose their jobs in the event of lay-offs, their entry into unemployment poses some serious problems. Older workers may find that their firm-specific skills are not an asset on the labour market; often they have built up their human capital in a single firm. It may prove difficult for them to learn new skills. Potential employers may consider them as poor prospects for employment because of factors such as a higher likelihood of health problems and insufficient time to recoup their retraining investment.

The outflow from unemployment depends also on the number of job vacancies and offers of employment. In a recession, the number of vacancies is limited. Employers, meanwhile, have a larger pool of unemployed from which to fill these few positions. In such a situation, unemployed workers with the least attractive characteristics, particularly those with no skills, will be pushed down the hiring queue, and the probability for them to remain unemployed for an extended period will increase.

An unemployed worker who sees his chances of being hired steadily growing worse may decrease the intensity of his job search as disillusionment sets in about the prospects of ever finding employment. And as if the picture was not bleak enough, his work skills may start to deteriorate from lack of use.

Not only is the probability of exiting from unemployment the lowest for older workers, but it has also declined significantly in the 1980s, falling from 52 per cent in 1981 to 24 per cent in 1989.

Policies and prospects

The federal Job Development Program, which is designed specifically to serve the needs of the long-term unemployed, has so far enjoyed some success and, overall, is relatively inexpensive. Nevertheless, the program has some clear shortcomings. The first concerns the eligibility criteria for admission and the second the lack of specific emphasis on older workers affected by long-term unemployment.

On the basis of analysis done at the Council, the authors conclude that the current six-month waiting period may be too long. They suggest that it be shortened to four months. Among other things, earlier identification will help forestall the skill erosion caused by long-term unemployment.

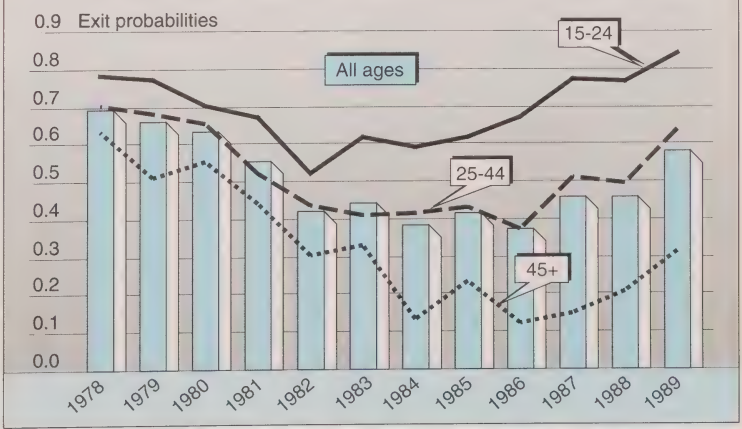
As for the problems of older workers, the authors point out that the Program for Older Worker Adjustment (POWA), the only major program in this area, replaces incomes, but it is costly and ignores the potential of productivity of older workers.

One solution would be to increase the level of employment subsidies for older workers, as has been tried in Australia and Germany. Such a measure would serve to increase the incentive to hire older workers.

In a similar vein, the experience of the Organization for Economic Cooperation and Development (OECD) suggests that programs aimed at generating self-employment have had encouraging results.

In conclusion, the two researchers argue that while compensatory programs like POWA can certainly ease the burden of these workers in the short run, in the longer run their integration into the regular workforce deserves special policy attention. Finally, in view of the regional disparities in long-term unemployment experiences, the authors note that policies addressing the plight of the long-term unemployed need also to recognize regional industrial diversities.

Exit Probabilities for the Long-Term Unemployed, by Age Group, Canada, 1978-89



The wave of the future

Distance education

The Economic Council of Canada has, for almost a year now, been working on a vast research project on education. Some preliminary findings are already available. A member of the research team, Jeannine Baillliu, has written for Au Courant *a piece on "distance education," an innovative educational technique aimed primarily at fostering accessible, flexible, and universal learning for all.*

There is widespread agreement that Canada's future prosperity is contingent upon a well-educated, highly skilled, and technologically sophisticated work force.

Canadians must possess not only a basic education but must, in addition, constantly train, retrain, and upgrade. As well, Canadian adults who are functionally illiterate, have not yet finished high school, or are simply unskilled, must be provided with the necessary opportunities to be educated, trained, and upgraded.

In this environment, education and training systems must be increasingly innovative and flexible. The changing nature of the student body has put new demands on the traditional education system. The majority of post-secondary students are no longer young adults registered in full-time day programs, and a growing number of secondary school students are no longer teenagers.

The new group of Canadians seeking to upgrade their education or skills is increasing in size and diversity. This group includes full-time employees, individuals with family obligations (especially women), disabled persons, illiterate or unskilled adults, native Canadians, and individuals who find the conventional-style education system inaccessible. For them, continuing education, part-time studies, coop programs, and flexible training programs (including on-the-job training) are gaining popularity and acceptance.



University of Ottawa

The creation of electronic classrooms plays an important role in the preparation of distance education programs.

Among this group of innovative new education techniques, "distance education" is a method that has experienced explosive growth in the last decade in Canada and is becoming an increasingly sophisticated learning process.

Distance education is a learning process where the learner and the teacher are physically distanced. This distance can be as little as a few miles or as much as several thousand miles. Initially, distance education was created to serve students who were far from a learning centre. Today, this concept has been extended to include any students for whom the conventional-style education programs are inaccessible for reasons ranging from full-time jobs to problems in finding suitable daycare.

Distance education now includes written correspondence courses, audio and video cassettes, audio and video teleconferencing, television, computer assisted learning, and an elaborate support system for the distance learner.

Fascinating possibilities

The possibilities for distance education are fascinating and endless. For example, the Quebec Ministry of Education in the mid-1970s wanted to provide training for the province's high school mathematics teachers. Through a program designed by the Télé-université, the province was able to ensure the upgrading of 60 per cent of its math teachers over a period of 10 years. All at a distance: equal accessibility for all teachers, no need to move anybody, and no absence from work required.

A similar need for upgrading has arisen in the medical field. Under new legislation, all Canadian nurses must have a university degree by the year 2000. This could create difficulties for nurses who are not able to return to full or part-time studies for family, economic, or geographic reasons. Many Canadian universities, including the University of Victoria and Lakehead University, have developed a B.Sc. in Nursing at a distance to meet the upgrading needs of this profession. The applicabilities of the method of distance teaching in education and training will abound as we make our way into the information and technology era.

The majority of distance education programs use print as the main medium

backed up by other technologies. The University of Athabasca, for example, uses mainly print and telephone tutoring, with some courses employing radio, television, workshops, field trips, and labs. The University of Waterloo makes extensive use of audio cassettes in its distance education courses while Cambrian College (Ontario) has turned to teleconferencing to deliver many of its courses. The Télé-université makes extensive use of television in its course delivery through the CANAL network in Quebec.

Computers are increasingly being used in learning at a distance. The Ontario Institute for Studies in Education (OISE) has explored the possibilities of conducting graduate studies in education using computer conferencing. The current Masters of Education program at OISE is offered at a distance (a minimum of two courses are taken on campus) through computer-based seminars and two face-to-face workshops with the instructor (one at the beginning and one at the end of the program). Telecom Canada regularly trains its staff at a distance using audio and video teleconferencing technologies.

Improved support services

Technology has not only modified and enhanced the delivery of distance education and increased opportunities for the learner to communicate with the teacher, but it has also enabled providers to greatly improve support services to students. More specifically, the development of certain communication technologies such as electronic mail, fax machines, on-line databases and information banks, audio, video, and computer conferencing have greatly reduced the isolation associated with distance learning.

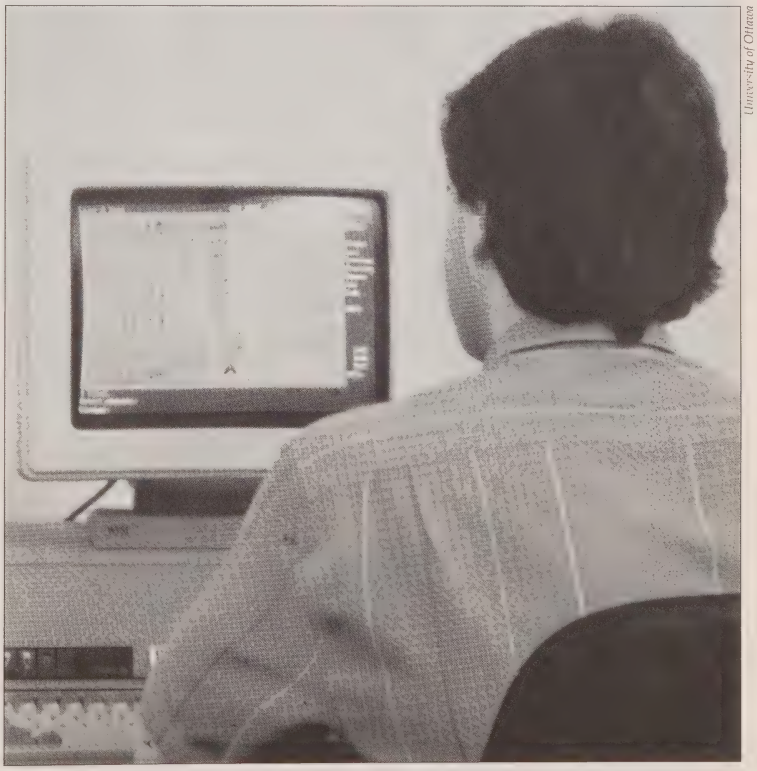
However, there is a concern that many of these distance education programs or support systems would not be available to all students. It can be assumed that the majority of students have access to a telephone, mail service, a television, and a radio; but, accessibility to a VCR, a computer or the technology to take advantage of electronic mail, databases, and conferencing (audio, video, and computer) is not widespread. Not only is use of the equipment limited, but often individuals do not have the skills to learn how to use these technologies on their own, and the prospect of using them might discourage potential students.

Counselling and skill development (for example, study and computer skills) have also become an important element in distance education programs, being delivered both through regional centres and at a distance. This component was added in an effort to reduce the isolation of distance learners and meet the individual needs of each student, especially students who may be returning to school after a long absence and lack certain skills to succeed, or who require guidance.

The creation of regional support centres and "electronic classrooms," and the involvement of such institutions as universities, colleges, and community centres in providing resource centres for distance education students, also represent an important step in dealing with the concern over accessibility. Many universities and colleges involved with distance education have developed regional support centres where students can attend workshops or seminars, meet face-to-face with tutors, interact with other students in their program, and write exams.

Electronic classrooms (ECs), a structure providing students with all the necessary tools used in distance education, are being set up across the country. ECs are equipped with fax machines, computers, teleconferencing capabilities, VCRs, and televisions, and are often linked to networks for access to electronic mail and data banks (providing students with full library services). Students must pay user fees unless they benefit from a network funded through an organization, usually in conjunction with provincial governments.

Contact North, an Ontario government-funded project, provides a network of electronic classrooms for use by students in northern Ontario. Students on this



University of Ottawa

There has been a phenomenal growth in distance education in Canada over the last decade.

network can use these electronic classrooms free of charge provided they are registered in a course approved by Contact North. Saskatchewan has a similar project underway to set up funded electronic classrooms through the Saskatchewan Communications Network (SCN).

Provincial educational broadcasters have played a major role in distance education in Canada. There are five licensed educational broadcasters in Canada: the Knowledge Network (British Columbia), ACCESS Network (Alberta), SCN (Saskatchewan), TVOntario, and Radio-Québec. These networks produce and broadcast educational programming for both general viewer interest and as an integral part of a formal course. It was estimated that the four networks in operation in 1987-88 reached over 6.2 million Canadians in both official languages.



The trend towards cooperation

The trend in distance education, regionally, nationally, and internationally, is towards cooperation – ranging from a simple exchange of information to more formal arrangements. Collaboration is especially important in course development. It is preferable to pool resources to develop one good course or program that may be used by several institutions, rather than develop several lower-quality courses in the same field.

The Open Learning Agency (OLA) in British Columbia is a good example of a province-wide consortium. The OLA was formed in 1988 as a degree-granting institution grouping the Knowledge Network, B.C.'s educational network, the Open University of B.C., and the Open College of B.C. The OLA offers a variety of both formal credit courses (secondary and post-secondary level) and non-credit interest courses, and coordinates activities (e.g. credit transfers) among post-secondary institutions involved in distance education in British Columbia.

There is enormous potential for distance education in Canada because it extends the reach of education and training to people who were badly served by or left out of the traditional educational system. An employed adult finishing his/her high school diploma, a group of office clerks in a company upgrading their computer skills, a homemaker with young children preparing to reenter the work force with a college diploma or University degree, an engineer being retrained to make use of new technologies: all can be distance learners. It's the wave of the future.

Competitiveness and the public sector

Economic globalization has set off a fierce struggle in which a long list of new and old competitors are striving to grab a larger market share. For all countries caught up in this maelstrom, there is a single watchword: "competitiveness."

Without a doubt, one of the greatest challenges of the new decade will be to continue to improve the ability of Canadian industry to meet the test of the marketplace. At the same time, there is a growing awareness that governments at all levels have an important bearing on the performance of Canadian industry. Does public-sector involvement inevitably affect Canada's competitiveness? If so, what is the nature and scope of this impact? In what ways does it manifest itself? Clearly, the range of questions about the impact of governments' activities is enormous.

Such is the background for the launch of an ambitious new research project by the Economic Council of Canada at the express request of the Prime Minister, Brian Mulroney. Its purpose is to examine the impact of Canada's public sector on the country's competitiveness. More specifically, the study will assess the effects of major elements of federal, provincial, and municipal policies with respect to revenue, expenditure, debt, and regulation on Canada's ability to meet the test of international markets while maintaining and expanding the real incomes of its citizens.

The context

Governments' impact on the productivity of Canadian enterprise is a concern that is being raised more and more frequently in a number of circles. It has been suggested that government action may actually impede economic well-being because of its inappropriate impact on productivity growth. Moreover, the possibility of far-reaching change in the structure of the Canadian federation could also have important consequences for the performance of the Canadian economy.

The first step is to identify the major factors at work in the present situation. For example:

– the competitiveness of Canadian industry has deteriorated in the 1980s;
– Canadian governments are struggling to overcome major fiscal imbalances, with the result that tax burdens are increasing and expenditures are being curtailed. At the same time, public investment in human and physical capital is essential to productivity growth;
– the public sector plays a more active role in Canada than in some other countries. Canada has also made different choices from the United States about how to provide certain public services. In particular, the Council's project has to take into account that the net cost to society has to be financed in ways that do not erode the country's competitiveness;
– provincial and municipal governments account for an increasing proportion of public-sector activity. Consequently, new internal systems are needed for harmonizing standards and regulations and for coordinating policy; and
– overlapping activities and the duplication of effort by governments are giving rise to tensions among governments. Some provinces are calling for changes in the division of powers.

A large number of social, cultural, and political forces must be taken into account in any reform of the structure of government; this study will focus on economic issues: specifically the efficiency and cost of the existing system.

Scope of the study

According to Economic Council Chairman Judith Maxwell, the Council will develop its research plan in consultation with the Department of Finance and will solicit the views of provincial and municipal governments, as well as those of private-sector organizations.

Given the project's timeframe, it will not be feasible to undertake a complete inventory of all public-sector activities and to assess their impacts. Rather, states Mrs. Maxwell, the aim will be to identify areas where there are gaps in current knowledge and to establish the priority areas for research. She feels that the study must be able to provide the information and analyses needed to address both the macro and micro aspects of the public sector's impact on the Canadian economy.

In particular, the project will attempt:

– to determine how government decisions in the areas of revenues, expenditures, debt, and regulation influence the competitive position of Canadian industry;
– to document the activities of federal, provincial, and municipal governments, to analyze how these activities have changed over time, and to assess the implications of overlap and duplication;
– to compare the cost of government activities in Canada with those in other countries;
– to identify the positive effects of government activities on private-sector productivity and the well-being of Canadians;
– to determine whether there are limits on the efficient size and growth of the public sector, and, if so, whether those limits may be changing in response to economic globalization; and
– to analyze the means by which governments might achieve their social and political objectives while reducing the cost burden on the private sector.

The role of the Council

In Mrs. Maxwell's view, the Economic Council is ideally suited to undertake such a study because it is an independent research organization with a national mandate to give policy advice on medium-term issues of importance to Canadians.

The project will be directed by Bryne Purchase, a former Assistant Deputy Minister of the Ontario Treasury and recently attached to the C. D. Howe Research Institute.

As with most Council projects, an advisory committee will be formed to monitor the study's progress. It will be composed of Council members, representatives from federal, provincial, and municipal governments and the private sector, and experts from relevant fields of study.

Because of the intense interest in the topics to be explored, the project will be designed in such a way that public officials and private-sector interests will have access to the results as they become available. An interim fact book will be published in late 1991 to inform the general public about the roles and responsibilities of governments.

Public and private experts will also be invited to participate in workshops and a conference on key results sometime in 1992.

Costs, quality, and access

Challenges for health care services

This is a critical time for the funding of health care services across Canada. Even though the quality of the Canadian health care system ranks high among the industrialized countries, many Canadians are aware of rising costs and worry about the quality and future accessibility of health care services.

Some people claim that Canada's approach to health care is wasteful and that there is an urgent need for improving the system's efficiency and the quality of care. Others believe that the Canadian health care system is under siege. They fear that less government funding will cause a deterioration in the quality of care and lead to the abandonment of the system's universal coverage, and eventually create a two-tier system – one for the rich and one for the poor.

The Economic Council of Canada has just embarked on a major research project in the hope of shedding new light on this vast subject and to explore, as far as possible, how to make the most effective use of our health resources.

To find out more about the Council's project, *Au Courant* interviewed its research director, Senior Economist Ludwig Auer.

Au Courant: *What are the broad objectives of your study?*

Auer: The central objective of this project is to inform the public and to assist governments in making difficult health care choices. We intend to do this by examining the economics of the health system, by exploring the potential for improvements, and by suggesting what economic incentives would be most appropriate for a better allocation of resources. We want to identify the underlying causes of the rise in health care costs, explore how much of the increase comes from the aging of the population, how much comes from more intensive treatment, and how much from the adoption of more advanced medical technologies.

We intend to quantify how much money could be saved by doing what's being done now more cost-effectively, how much could be saved by changing the mode of delivery of health services, and how the system could continue to provide high-quality care to all Canadians, on an equitable basis.

Au Courant: *How will your research differ from the previous work done on this subject?*

Auer: We have no intention of reinventing the wheel. Excellent research has been done in many areas of health economics, ranging from the cost-effectiveness of tetanus immunization to that of water fluoridation, from the cost of Caesarian births to that of coronary bypasses, from the cost of health care for the poor to that for the rich, and from provincial to international variations in the utilization of health care services.

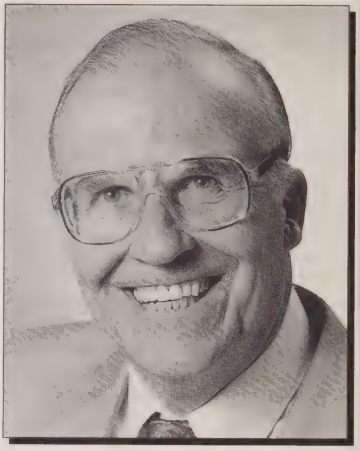
Our analysis will build on the findings of many of these studies. We intend to integrate them into a systematic framework. As far as possible, we are going to examine the real health care inputs, that is personnel, material, and capital requirements, and will also focus on the outcome in terms of years of life gained and improvements in quality of life. We will also analyse and compare all provinces, funding permitting, and integrate this information to explore systematically the potential for a better allocation of resources.

Au Courant: *Have you already identified some particularly troublesome areas? If so, what are they?*

Auer: Inevitably, the economics of the health care system will become entangled in ethical issues.

By now it is well established that a large part of all hospital costs are spent on individuals who are in the last three years of their life. Some people have begun to question the merit of using the most sophisticated and costly life-saving technologies in treating the terminally ill.

At the same time, they are very reluctant to advocate a shift of health resources from less to more effective use because it would require making "explicit" judgments on the dollar value of the lives of individuals. Yet others do not refrain from implicit value judgments when they make seat belts obligatory, or mandate occupational safety standards, build more fire stations, prohibit smoking



L. Auer

in public buildings, or favour gun control.

Unless we do address such issues, however, we cannot come to grips with the question of optimal economic allocation of resources. This will require not only a critical evaluation of the economic options but also an explicit assessment of the underlying ethics. And, no doubt, that will raise some troublesome questions.

There are other problematic issues. Much research has been done on the impact of smoking. On the basis of that evidence, we can estimate by how much it shortens life expectancy. Similarly, it is possible to estimate by how many years selected surgical interventions – e.g. appendectomies – lengthen life expectancy. But when it comes to changes in the mode of service delivery – e.g. the shift from nursing homes to home care – or when we ask what more extensive training of nursing staff in accounting will do for the health of the patient, we run into difficulties quantifying it. As in many other service industries, there are large gaps in our knowledge of the real input/output relationships and, by one technique or another, we need to bridge them.

Au Courant: *Will you be looking at the social aspect of health care?*

Auer: Many studies have shown that poverty shortens life, and it appears to make little difference whether access to

health care is free or not. Social stress is detrimental to health.

This is a perplexing issue, because it hinges not only on the disparity between rich and poor but also on the difference in lifestyles. We know that personal income, educational attainment, and lifestyle are closely related. To provide more health care services will not lead to the optimal use of resources when our efforts ought to be directed at changes in lifestyle. We are going to explore this issue.

We are also going to look at the variations in access to health services between rural and urban areas to see if in fact they are associated with variations in mortality.

Au Courant: *Will the aging of the population have any bearing on your research?*

Auer: There is a pervasive concern that we are an aging population, that our health resources are limited, and that in the future there will not be enough public funding to make ends meet.

The fact is that Canada's population is aging very slowly and its age composition will change little until the babyboomers of the 1950s reach pensionable age in their sixties, which will not happen until after the year 2010.

But we also know that over the past two decades a more intensive medical technology has contributed several times as much to health care costs as the aging of the population did. Our research will have to deal, therefore, not only with the impact of aging of the population but with medical technology as well.

Au Courant: *Lifestyles have changed, people are quitting smoking, enrolling in physical activities of all sorts. Could those be factors in the health care system of the future?*

Auer: Prevention can add more years to life and do more for the health of the population than more intensive care. We want to examine what changes in lifestyles can do to improve health. We intend to assess the costs and benefits of such measures as the reduction of occupational hazards, non-smoking campaigns, compulsory use of seat belts, and even explore the impact of socio-economic stress.

Au Courant: *How does our health care system compare internationally, quality-wise and cost-wise?*

Auer: By international standards Canada's health care system ranks high among the industrialized countries. It is an equitable system with easy access for all. It compares well with that of most European countries as well as our neighbour to the south. To illustrate: Canada's health insurance covers everybody, whereas in the United States some 35 million people have no coverage at all. Canada's health expenditures account for roughly 9 per cent of the GNP whereas U.S. expenditures account for about 11.5 per cent. Many factors contribute to the lower costs in Canada, among them: a somewhat younger population, lower fees for surgical interventions, less specialized physician services, less costly liability insurance, a lower level of amenities in the average physician's office, lower incomes of physicians, more centralized and less costly administration of the whole system, and prospective global budgeting by governments.

Au Courant: *Can we still afford the universality principle of our health care system?*

Auer: The Canadian health insurance system gets high marks for cost control and universality of access. It does not compare so well when it comes to innovation, entrepreneurship, and growth of alternative health maintenance and provider organizations – aspects that may be important over the long run, where they could add to service quality, consumer satisfaction, and personnel morale.

The question is not so much whether we can afford universality but how much we are prepared to pay for a "better" health care system, how the economic incentives should be set for health providers and consumers to make the system more effective, and who should pay for what.

Au Courant: *Could we really maintain the same health care services at a lower cost?*

Auer: Research has shown that improvements could be made to lower the cost of care and keep the quality up. In some areas, the evidence is conclusive; in others, it is not.

In the goods-producing industries, the adoption of new technologies often leads to "cost reductions." In the health care sector it frequently leads to more intensive services and "cost increases." We intend to examine very closely the potential for savings coming from the substitution of specific health care interventions within institutions in some cases and the substitution of services between different health care institutions in others.

Au Courant: *Would the current jurisdictional framework impose limits to any restructuring of the health care system?*

> ***"Research has shown that improvements could be made to lower the cost of care and keep the quality up."***

Auer: Health care falls primarily under the provincial jurisdiction. As long as the federal government contributes to the funding of health care services, however, it may act to serve the national interest. To qualify for federal financing, the provinces must meet the conditions of public administration, comprehensiveness, universality, portability, and accessibility, as specified under the Canada Health Act. Unless there are dramatic changes in Canada's constitution, these conditions leave ample room for modifications and they will not impose critical limitations.

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Employment in the Service Economy (EC22-172/1991E; $21.95 in Canada; US$26.35 outside Canada).

This report presents the Economic Council's research on the growth of the service economy and its implications for employment. It details and extends the analysis highlighted in *Good Jobs, Bad Jobs*, a Statement released by the Economic Council in 1990. Employment in the service economy begins with an examination of service industries, the factors behind their growth, and linkages between services and the goods sector. It concludes with a set of policy recommendations put forward by the Economic Council to enhance job creation and maximize the contribution of Canada's human resources in the changing environment.

Economic and Social Impacts of Immigration (EC22-176/1991E; $19.95 in Canada; US$23.95 outside Canada).

Recent falls in the birth rate have raised the question of whether immigration should be increased in order to sustain population growth. The Council addresses this question, and the more general issue of the advantages and disadvantages of immigration. Positive effects are found on per capita income for the host community, through scale effects and an easing of the burden of paying for future care of the elderly, but the gains are very small. At the same time, an often-expressed fear about immigration, that it causes unemployment, is found to be largely groundless. The Council also found that prejudice, though still to high, has been decreasing, and is notably lower in communities with high proportions of visible minorities. The Council concludes that everyone can benefit from more immigration, provided it is phased in slowly. It recommends a gradual build-up to 1 per cent of the Canadian population per annum by the year 2015.

Studies

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Working Papers

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No. 16 "The Anatomy of Disparities," by *Neil Swan* and *John Serjak*.

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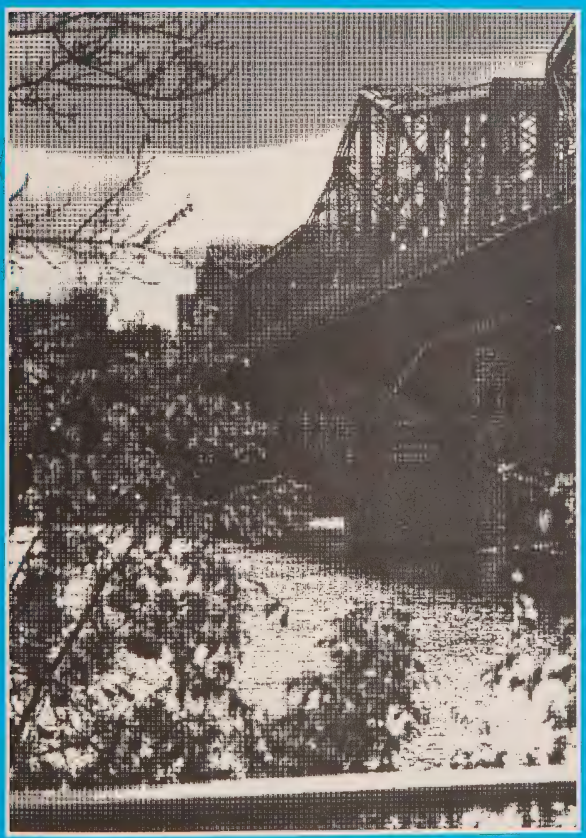
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A Joint Venture

The Economics of Constitutional Options



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- Mergers and acquisitions
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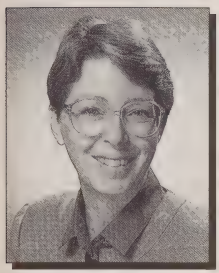
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Sharing the same economic destiny



Judith Maxwell

This country is diverse. Our distances separate us. The result is that Canadians do not fully understand how integrated the economy is. Indeed, when times get tough, as they are now, many Canadians fail to recognize that we all share the same economic destiny.

The Council's 28th Annual Review, *A Joint Venture*, points out that despite the process of globalization, and stronger north-south economic ties, interprovincial trade is and will remain important to Canadians. Roughly 2 million jobs are directly associated with interprovincial trade in goods and services. Most provinces sell half or more of their exports of goods and services in other provinces. This domestic market provides the testing ground where Canadian firms can build their strength in preparation for international competition.

The Review also documents the fiscal ties that knit us together. Most Canadians are aware that there is an equalization program which provides for sharing between rich provinces and poor provinces. What they do not realize is how much hidden equalization there is in our social safety net. Most Canadians have access to the same social programs, no matter where they live, at roughly comparable tax rates. Such social programs would be difficult, if not impossible, to support if every province tried to provide its own programs. This important point shows up when the Council does its examination of different stylized constitutional options for Canada.

The Review sets out to test the degree to which the country could decentralize, while retaining the essential economic union which provides benefits to all Canadians. How far can the economic union be stretched in order to accommodate the desire for diversity among provinces?

The Review demonstrates that there are real limits here. In the case of extensive decentralization, where provinces take over responsibility for all social programs and all subsidies to business, we find that there are losses in income per capita for all regions in Canada except Ontario and Quebec. These losses bear witness to the way the fiscal ties in the country support regions facing economic adversity.

For example, the Atlantic provinces lose when programs are decentralized, because their tax base would not provide enough revenue to be able to afford the kind of unemployment insurance system which is now in place. In contrast, Alberta would lose out because it would have to pay for its own subsidies to farmers. Manitoba and Saskatchewan, which benefit both from unemployment insurance and subsidies to farmers, would also experience a severe setback in income. Even British Columbia would be a loser in this particular option because its unemployment rate tends to be higher than the national average.

Of course, I hasten to point out that the fiscal linkages are only one aspect of the overall costs and benefits that have to be assessed when one examines these stylized political options. As the Council points out in the Review, there are important transition costs involved in any radical change in the division of powers between federal and provincial governments. Similarly, we note that strains on the economic union begin to emerge when disparities in tax rates between provinces widen. People and investors will quite naturally migrate from high tax regions to low tax regions if such disparities get too wide.

Canadians all have a lot at stake in the Canadian joint venture. So what to do?

We need to improve our capacity to coordinate decisions among governments. Governments have laboured long and hard to agree on reducing interprovincial trade barriers in the last few years. It would help if all provinces became active supporters of the economic union. The key issue now is the federal constitutional proposals. They provide a blueprint for coordination which now needs to be shaped by all the players, especially the provinces.

We also need to compromise on a vision of sharing that provides Canadians with the reassurance that the political system in this country provides an adequate level of support for people facing economic insecurity.

The basic message that comes from the Council's analysis is that we are all travelling in the same boat. We have long since abandoned the era where the boat was commanded by a federal captain who called all the shots. What we have not yet found is a way to keep all the crew working towards the same objectives, aware of the strengths, needs and constraints faced by the others.

A new relationship

The failure of the Meech Lake Accord set off a new, intense round of constitutional debate. Canadians will soon have to choose – through consultations, referendums, and elections – what kind of political and economic ties will eventually prevail among them.

The problem is highly complex, touching upon a number of areas that resist easy evaluation. In the economic realm, however, Canadians may be able to find their way out of the maze by focusing their attention on two specific issues:

– creating wealth; and
– defining the role of governments in deciding how the proceeds from economic growth and the risks of economic hardship will be shared.

This message is one of the central themes of *A Joint Venture*, the Economic Council's 28th Annual Review, which examines the stakes involved in the constitutional debate from an economic perspective.

A time to choose

The joint venture in which Canadians have participated since Confederation has produced a country that is among the richest in the world, with a quality of life that is the envy of citizens of many other nations. Yet, Canada is now going through one of the most troubled periods of its history.

On the political front, the failure to ratify the Meech Lake Accord was perceived in Quebec as a rejection of its distinct character. It also revealed profound discontent elsewhere with the way the existing political and economic systems operate. Since then, Quebec has established its own timetable for constitutional reform, but it is not alone in calling for change. The native peoples have clearly indicated their exasperation with the current state of affairs, and westerners too have expressed frustration.

These political forces are not the only threat to the Canadian joint venture. Economic and fiscal issues also pose a serious challenge to the current political structure and to federal institutions. After many years of building up the public sector, during which a variety of measures were instituted to strengthen Canadian social safety nets, deficits have grown to the breaking point. Canadians are now paying more in taxes and getting less service in return because debt repayment absorbs one third of tax revenues. This undermines the traditional leadership role of the federal government.

Although the current constitutional debate has, to some extent, exacerbated an already difficult situation, Canadians now have an unprecedented opportunity to rebuild the foundations of their joint venture and thus create greater prosperity for all. The Economic Council does not claim to have all the answers to those challenges. However, in its 28th Annual Review, entitled *A Joint Venture*, it attempts to lay out the economic background to the debate and to explain the issues at stake, at a time when Canadians stand on the brink of momentous decisions about their future.

The 28th Annual Review was completed under the direction of Jean-Pierre Voyer, with the assistance of Ross Preston for the medium-term economic analysis and forecast. The research team comprised David Péloquin, Kei Moray, James Nightingale, and Marcel Bédard. The Performance and Outlook team consisted of Richard Roy, Haider Saiyed, Andrew Burns, Gilles Bérubé, and Marg Willis.

The priority: creating wealth

It is clear, says the Council, that the current constitutional crisis is fuelled by a host of fiscal and economic pressures. In recent years, many Canadians have been unable to preserve their standard of living, let alone improve it.

The creation of wealth must therefore be viewed as the first step in solving the constitutional crisis. If everyone is wrestling for a bigger share of the pie, it only makes sense to ensure that the pie is big enough to accommodate them. Thus any viable option for political restructuring must begin by offering the possibility of better living standards.

The Council finds that governments, businesses, labour, and other economic players seem to lack the political will to address this challenge as a joint venture. Right now, the various parties vie for larger shares of an economy that is no longer expanding as fast as it once did.

Increasing the standard of living of Canadians means, first and foremost, improving productivity and emphasizing innovation in order to foster a diversified output that stresses higher-value-added products. Those are the keys to ensuring the success of Canadian products on world markets and creating good jobs for Canadian workers.

Policy coordination

Another key ingredient in the drive to raise living standards is the efficiency of the economic union. The Council's research indicates that the provinces cannot ignore the internal Canadian market. For each province, the rest of Canada constitutes a strategic trading partner: 19 per cent of the output of the average province is destinated to other provinces. Moreover, interprovincial migration may account for as much as 8 per cent of yearly job changes in the Canadian labour market.

Whatever political structure is adopted, the federal government and the provinces must share responsibility in managing the Canadian economic union. This will require, in particular, a firm commitment on the part of the provinces to dismantle interprovincial trade barriers and, even more important, to work towards the

coordination of federal and provincial economic policies.

The federal government no longer has the economic clout to operate on its own. The situation demands joint accountability by Ottawa and the provinces to ensure the efficient operation of the union and harmonize their economic objectives.

Budget planning is an area where governments can do a much better job of coordinating their efforts. Accordingly, the Council calls for an end to the tradition of budget "secrecy," for coordinated budget planning, and for regular assessments of federal and provincial fiscal plans.

Terms of the joint venture

There is another important issue facing all Canadians: Do they want to maintain similar policies across the country with respect to the redistribution of income and the sharing of the risks of economic adjustment? Should common standards of service and taxation across the country remain a fundamental aspect of Canadian citizenship?

Faced with accelerating technological advance and the pressures of international competition, Canadians as a whole agree that a strong social assistance system and a variety of social insurance plans must be preserved in order to protect citizens against economic misfortune. The Council's research shows that the elimination of equalization would make it impossible for the have-not provinces to deliver social-welfare systems to their residents at tax rates comparable with those in other provinces.

But even if Canadians agree that social insurance and some form of equalization should be maintained, the fundamental dilemma remains. What is the most appropriate philosophy of sharing? A "broad" vision, which states that all Canadians should have access to similar public services with roughly similar tax burdens? Or the "communities" vision, which argues that regional variations in program standards are acceptable, perhaps even desirable?

The question can be put more bluntly. Should elderly people in Cape Breton, the Beauce region, and the Okanagan Valley have access to roughly the same social-security and health-care services? Should we strive for education and training opportunities that are similar across the country? Or should each province instead be responsible for setting its own standards and developing its own programs?

These questions have to do with determining how responsibilities should be divided between the federal government and the provinces, and whether or not national standards in public services are required.

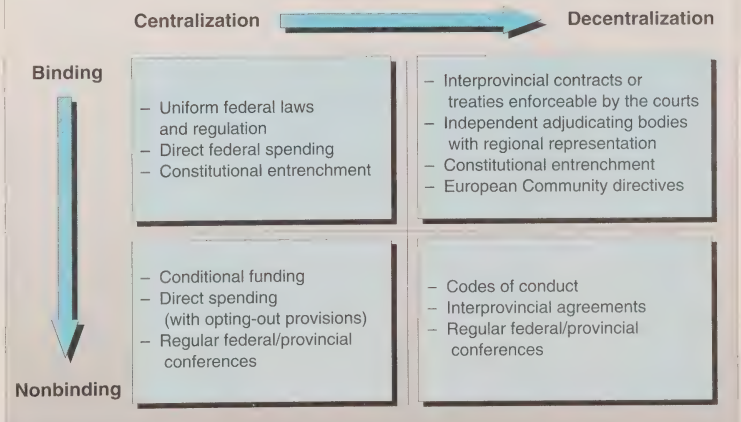
For both political and fiscal reasons, the tide is currently running in the direction of decentralization. However, fiscal considerations may well lose some of their importance in coming years. It would be wrong to think that the federal government will be permanently handicapped by its current financial difficulties. The Council's projections show that there could be a turnaround in the fiscal picture by the mid-1990s, enabling the federal government to repay its debts and consider tax cuts or spending increases.

An efficient economic union must have both guarantees and a degree of flexibility. No matter which option Canadians choose – centralized or decentralized federalism – the rules of the game, whether they are binding or nonbinding, can be determined so as to accommodate all parties. But it will not be easy to define those rules. Binding rules offer greater stability and better guarantees for citizens, but they tend to impinge upon provincial autonomy and are therefore more difficult to negotiate. Nonbinding approaches, on the other hand, are clearly easier to negotiate, but they offer no guarantee against bad faith or a change in government priorities.

The upshot is that provincial autonomy depends not so much on the degree of decentralization as on the decision-making rules and mechanisms governing interprovincial agreements. If Canada decides to pursue the path of extensive decentralization, it might become necessary, says the Council, to institute more-binding mechanisms in order to ensure the efficiency of the economic union.

If it happens that Canadians are unable to agree on a single unifying formula for sharing, they need not abandon their joint venture, stresses the Council. Given the Canadian tradition of tolerance and mutual respect, the Canadian federation may turn out to offer the latitude needed to forge more-asymmetric arrangements permitting the coexistence of different sharing formulas within a common political structure.

Alternative Mechanism for Preserving the Economic Union



Policy coordination

The maximum benefits of the economic union will accrue to Canadians through cooperation and coordination between governments.

According to the Council's 28th Annual Review, one of the key challenges for Canada over the next several years will be to find new ways to ensure policy coordination – not only among the provinces themselves, but also between the provincial governments and the federal government – in order to manage the economy more coherently. Besides natural barriers of distance and language, there are also artificial obstacles to greater integration of the Canadian market. Among them are government initiatives in such areas as taxation, spending, and regulation that interfere with the free flow of trade, capital, and labour. Some of the economic difficulties plaguing the economic union are the result of a lack of coordination in government action in such key areas as taxation and fiscal policy.

Greater cooperation between governments at all levels should be regarded as a priority within the present political structure.

Economic linkages

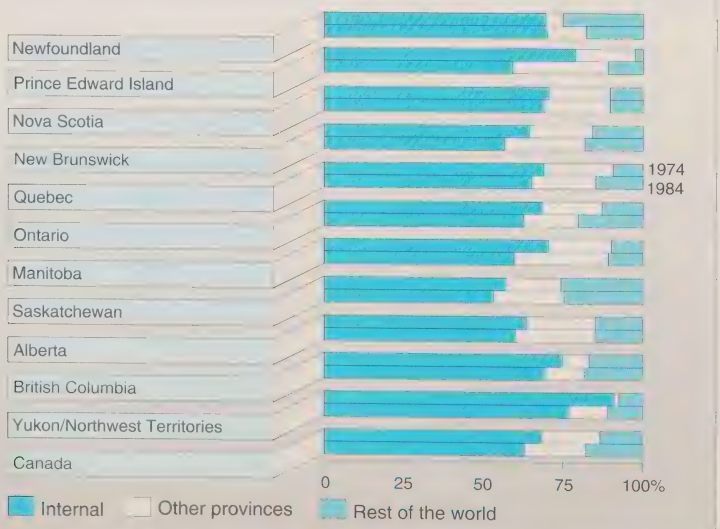
East/west linkages between the provinces do not seem to have weakened in the face of the globalization of markets and the expansion of north/south trade. In all provinces, the local market remains by far the most important. In 1984, for example, nearly two thirds of gross output in each province was sold in local markets. In addition, interprovincial trade as a proportion of gross output was more important than international trade: 19.3 per cent vs. 17.5 per cent. In 1990, interprovincial trade alone may have accounted for about 2 million direct jobs.

The volume of interprovincial trade in goods seems to be higher in Canada (18 per cent of GDP) than within the European Community (13 per cent) or the European Free Trade Area (4 per cent). This is all the more remarkable when one takes into account such factors as the greater distances within Canada, its smaller population, and its greater dependence on resources.

The pattern of trade flows for Canada as a whole conceals important differences between the provinces. Between 1974 and 1984, the ratio of international trade to gross output rose substantially for Ontario, Quebec, and Prince Edward Island; for New Brunswick, Manitoba, and British Columbia, the increase was much more modest. The situation remained the same in Nova Scotia and Alberta, while the ratio declined in Newfoundland and Saskatchewan. For Ontario and Quebec, the share of output destined for markets in the rest of Canada decreased, while for all other provinces it increased, sometimes substantially.

It is interesting to note that the pattern of trade between provinces and their foreign markets is heavily influenced by geography. The western provinces tend to export relatively more to Asia, while European markets are more important for the Atlantic provinces. All provinces sell the larger part of their total exports to the United States, the proportion ranging from a high of 88 per cent for Ontario to a low of 41 per cent for British Columbia. Geography also plays a role in the pattern of trade with U.S. markets.

Destination of Provincial Output, Canada, 1974 and 1984



Interprovincial links

Ontario and Quebec sell more to each other than to any other part of Canada. In 1984, Quebec exported products worth $18 billion to Ontario (11.7 per cent of its gross provincial product), while Ontario shipped $21 billion worth of product to Quebec (7.5 per cent of its gross product). The latest provincial figures indicate that Quebec's exports to the rest of Canada – and to Ontario especially – have increased sharply. Next to Ontario, Quebec's most important markets within Canada are Alberta and British Columbia, where 1.9 and 1.5 per cent of its gross output are sold, respectively.

All provinces have significant trade ties with Ontario and Quebec, but trade links between the Atlantic and western regions are almost negligible: the Atlantic region exports only a tiny portion of its output west of Ontario; conversely, the western provinces depend very little on markets east of Quebec.

Corporate links

The operations of branch offices and links between parent and subsidiary corporations represent another important aspect of interprovincial linkages. Such

activities can either substitute for or complement interprovincial trade. When a firm holds a controlling interest in another firm, it can make strategic decisions for it. This has both positive and negative aspects. On the positive side, intercorporate linkages can provide access to technologies and to best-practice management methods. On the negative side, economic decisions made outside the province may have a negative impact on the local economy, since spending on research and development and promotions to management positions tend to favour the province where the controlling corporation has its head office.

The Council's analysis shows that the provincial revenue shares accounted for by locally controlled firms ranged from less than 50 per cent in Alberta and Manitoba to as much as 69 per cent in Quebec. While Quebec had the highest degree of local control of its corporate activity (as measured by corporate revenues), about 30 per cent of corporate activity involved firms controlled by interests in other provinces and in other countries. The share of corporate revenue controlled in other provinces ranged between 10 per cent in Ontario and 29 per cent in Manitoba.

Labour mobility

Canadians are quite mobile compared with people in other countries. During the 1980s, for example, no fewer than 320,000 people a year, on average, moved from one province to another. This degree of mobility is comparable with that of the United States and is higher than that of the European Community.

Even though migration from Quebec is limited by the language barrier, the net outflow from Quebec over the past 30 years has totalled half a million people – more than 7 per cent of the province's current population. Although net outflows have occurred every year since 1962 in Quebec, they were particularly large at the time of the FLQ crisis in 1969-70 and after the election of the Parti Québécois in 1976. Outflows have slowed considerably after 1984, with the strong recovery in Quebec's economy. In Ontario, net flows have generally been positive, except during the 1970s when the western economies were booming. After 1982, however, Ontario recorded a total inflow of 200,000 people.

Net migration flows have generally been negative for Manitoba and Saskatchewan. Although attracting large net inflows for most years since 1961, British Columbia lost population in the early 1980s. The Atlantic provinces, meanwhile, have generally experienced net outmigration, although the flow reversed in three of the four provinces during the 1970s following the reform of the UI plan in 1971.

Outmigration rates are much lower in Ontario and Quebec. Ontario's low rate is linked to the diversity, strength, and size of its economy. In Quebec, while the same factors play a role, language is the dominant explanation for the low rate of mobility.

Distance is again a critical factor in explaining linkages between provinces. Ontario is the clearing house of the national labour market. With the exception of Saskatchewan and the Northwest Territories, all provinces have strong links with that province. In the West, provincial labour markets are highly integrated with one another. This is particularly evident in Saskatchewan, where about 80 per cent of migrants go to other western provinces. The Atlantic provinces have relatively weak links with one another, but closer ties with Ontario.

Quebec has weak links with all provinces except Ontario and, to a lesser extent, New Brunswick.

Obstacles

Among the obstacles to the integration of the Canadian domestic market are government actions that discriminate against flows of trade, capital, or labour through tax, spending, or regulatory policies. Some of these policies implicitly discriminate on the basis of origin; others do not, but distort flows nonetheless. Other obstacles exist because of a failure to coordinate government actions in such key policy areas as tax structure and fiscal policy.

Some policies of the federal government also interfere with the common

Corporate Revenues Earned by Firms Controlled Locally and Non Locally, Canada, by Province, 1987



market, such as regional and industrial development policies, regionally differentiated UI benefits, and transportation subsidies.

Despite the various obstacles that shackle it, the Canadian domestic market remains extremely important for all provinces.

Thus, states the Council, "any changes in the political structure must be carefully judged to avoid disrupting this trade. To do so would be to disrupt the livelihood of many Canadians."

Under the current circumstances the Council does not support the idea of imposing legislative or constitutional measures to protect the integrity of the common market. It does recommend, however, recourse to federal-provincial negotiations to attempt to secure a commitment to eventually eliminating trade barriers.

In particular, new institutional arrangements will be needed to create a forum where political trade-offs can be achieved. In addition, the current mandate of the Committee of Ministers on Internal Trade to dismantle impediments to interprovincial trade should be reinforced.

New procedures for coordinating federal and provincial policies are needed in order to assist all regions of the country in dealing with the challenge of stronger competition resulting from the globalization of national markets and economies.

Fiscal harmonization

Differences in various governments' tax regimes also have an adverse effect on the health of the Canadian economic union. The purpose of tax harmonization is to ensure that the tax systems of the three levels of government operate in such a way as to limit the costs of collection and compliance. Taxpayers should be subject to the same rules, no matter where they live, so that capital and labour may continue to flow freely within the economic union.

Although, internationally, the Canadian federation is viewed as a model of tax harmonization, there have been worrying signs in recent years of fragmentation with respect to both income and sales taxes. Changes have allowed the provinces to introduce tax credits to individuals and corporations; such measures, says the Council, run the risk of compromising the high degree of harmonization that has been achieved through federal/provincial negotiations.

The Council believes that it should be possible to accommodate provincial requests for more flexibility within the national income tax system, as long as the following conditions are met: 1) a relatively comprehensive equalization system is preserved; 2) similar tax-base definitions are maintained in all provinces; and 3) there are uniform attribution rules for allocating personal income earned outside the province of residence.

Wide interprovincial differences also exist in the area of indirect taxes. To cite but three examples, sales taxes, tax bases, and tax rates vary considerably across provinces.

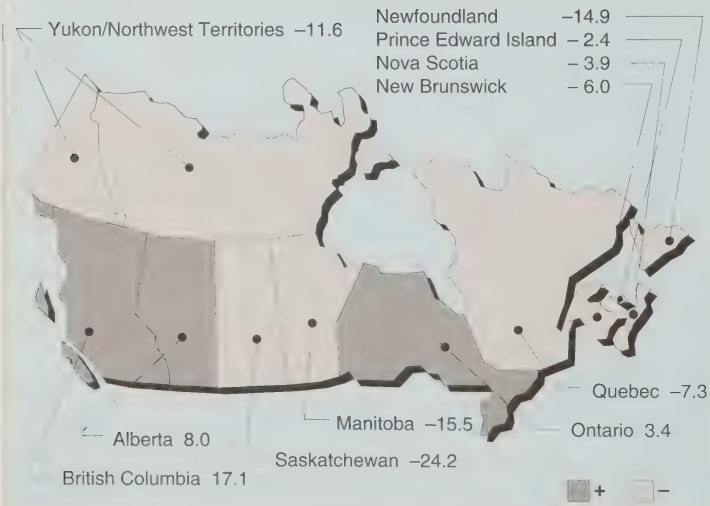
A new budget process

If there is one area where greater coordination is essential, it is the process by which tax and fiscal policy is developed. In the past, provincial tax or fiscal policies that contradicted national priorities could usually be counteracted by federal measures. Canadians seemed ready to accept these contradictions as one of the costs of diversity. Today, the thrust of economic and political forces is to create a new role for the provinces in the management and stabilization of the economy.

The Council suggests that the tradition of budget secrecy be abandoned, so that all governments may participate in setting economic targets and policies.
With the veil of budget secrecy lifted, the federal government would be able to make public its fiscal plan and economic forecast several months before actually tabling the budget. These initiatives would facilitate consultation with the provinces, which would be invited to present their own budget plans in the intervening months.

It would also be desirable to create an organization with an analytical capacity that would be mandated to identify inconsistencies between federal and provincial policies and to bring them to public attention.

Net Interprovincial Migration, Canada, 1961-91



Reconciling two different visions

The current political debate over the respective roles and responsibilities of the federal and provincial governments involves two very different perceptions held by Canadians on how the nation's wealth should be shared.

Tax equalization, national standards, and the simple question of how spending and taxation powers should be allocated among the various levels of government are all issues that involve political choices for Canadians. Two different visions of federalism exist – the "broad" vision and the "communities" vision.

The broad vision calls for a relatively robust federal government that can actively promote equity by, for example, ensuring equal treatment of individuals across the country and redistributing income from those who are better off to those worse off. This implies very similar (perhaps even identical) sharing mechanisms across the country. The broad vision thus focuses on similarities between the nation's citizens and sometimes asserts uniformity of government taxation and services as a basic right.

The second model, based on what might be termed the "communities" or "decentralized" vision, puts greater emphasis on the importance of responding to regional needs. It finds expression in the desire of many – particularly in Quebec but also in other parts of the country – for greater provincial autonomy.

While the clash between the two models has been evident since Confederation, the recent debate on the country's future has revealed some cracks in the consensus over how powers should be shared among the various levels of government. One measure of the importance of this debate is the fact that more than half of government expenditures are oriented towards sharing, either directly or indirectly.

In its 28th Annual Review, the Council explores the nature of intergovernmental fiscal arrangements and discusses how these arrangements could be adapted to more decentralized forms of federalism, while ensuring the preservation of a strong economic union.

While there is much scope for innovation in redefining the current division of powers, Canadians must consider fully the long-term effects of any changes.

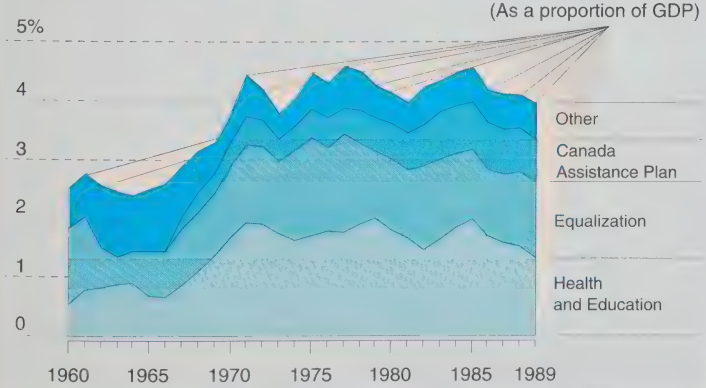
The budget crisis and federal power

There is little doubt that the budget crisis has shaken public confidence in the federal government's ability to play its redistributive role in recent years. Federal involvement in areas of provincial jurisdiction was traditionally justified on the grounds that the central government was paying some of the bills. By altering its commitments under existing fiscal arrangements with the provinces (among other actions), the federal government has unleashed pressures for decentralization.

Notwithstanding the federal government's fiscal difficulties, the Council advises caution in drawing conclusions from the current state of affairs. The future is not necessarily cast in stone. Indeed, according to some projections, the government's budget crisis will subside by the mid-1990s. While this is by no means a certainty, it would be a mistake to assume that extensive decentralization must inevitably occur simply because the federal government's room for manoeuvre is currently restricted by the state of its books. The crisis will not necessarily be a permanent handicap.

The cumulative effect of budget cutbacks and federal tax increases in the past few years may eventually produce a "virtuous" circle, which, by encouraging more-rapid economic growth, will make it possible for the government to reabsorb the public debt, reduce taxation levels, and so forth.

Federal Cash Transfers to Other Levels of Government, Canada, 1960-89



The allocation of powers

While it is sometimes tempting to view the struggle for power between the federal and provincial governments as nothing more than political squabbling, it is important to realize that the allocation of powers has real consequences for the state of the economic union and for long-term social cohesion.

To the extent that preserving or reinforcing the economic union is the goal of all Canadian governments, it must be recognized that decentralization may not increase the scope for independent action by provinces: increased powers inevitably entail increased responsibilities, but the need to coordinate provincial actions may limit their freedom of action.

Competition between the various levels of government may, depending on the circumstances, have harmful effects on the economic union because of policy incoherence, overlap or duplication. It can also have favourable effects, encouraging the development of better-quality public services.

How can such overlaps and duplication be overcome? The Council has a number of suggestions.

Obviously, the problem would disappear if Canadians were to opt for either extreme centralization or extreme decentralization. Between these two extremes, however, lies the option of entrenching a truly watertight division of powers in the constitution, which would also eliminate overlapping. This approach has the merit of clarity but it does sacrifice the flexibility needed for policies to be adapted to a constantly changing economic environment.

There is another possibility: continuing the practice whereby the two levels of government exercise more or less concurrent powers in the same policy areas but specifying which one has "paramountcy." For example, when the federal government would exercise its spending power in an area of provincial paramountcy, each province would be entitled to opt out and receive unconditional compensation.

Under this option, the two levels of government would be empowered to intervene in a new policy area where there are unmet needs, while the jurisdiction with paramountcy would be able to avoid costly, inconsistent, or contradictory regulations or spending programs.

National standards

Constraints on the growth of federal transfers in support of health care, postsecondary education, and social assistance have raised tough political questions: How can the federal government justify its imposition of national standards governing provincial programs in these areas when it is in the process of cutting back its financial contributions? Here again, the answer depends on one's point of view regarding the Canadian federation.

Total federal transfers in these areas, which will amount to nearly $14 billion in 1991-92, represent a key component of "implicit" equalization in Canada. They help to bring the fiscal capacities of the have-not provinces more into line with those of the richer provinces. It is the role these transfers play in setting national standards that is the most controversial, however.

Equity and efficiency concerns also enter into this question. It can be argued on equity grounds that national standards maintain a common set of rules and benefits that are the basic entitlements of citizenship.

There are some situations, however, where national standards may themselves create inequities, particularly if they force the provinces to spend more in certain sectors while significant gaps remain between them with respect to revenue-raising capacity.

The concept of efficiency is based primarily on the principle that national standards are essential to preserve and promote the economic union.

The one-sided nature of negotiations between Ottawa and the provinces has frequently been criticized. One alternative would be to make such arrangements more like "contracts" that would be binding on all parties for a fixed or indeterminate period and which could be enforced through the courts.

Another solution, modeled after the European approach, would give the federal government the power to set national priorities, subject to provincial approval, while allowing the provinces enough leeway to decide themselves what action to take to meet those goals.

Fiscal equalization

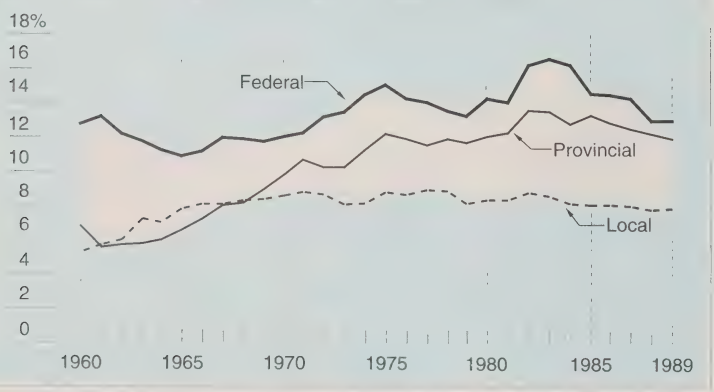
Like national standards, questions of efficiency and equity will likely remain important underlying issues in the debate on reforming Canada's equalization system.

The equity argument is straightforward. The equalization of provincial fiscal capacities ensures that, on the average, people in comparable circumstances – but living in different provinces – are able to enjoy similar public services. On efficiency grounds, equalization helps to maintain the integrity of the economic union, since disparities in fiscal capacity can lead to labour shifts that are inefficient for both the province of destination and the province of origin.

The greater the spending responsibilities of the provinces (particularly when differences in the corresponding fiscal capacities are wide), the greater the need for equalization – whether in implicit or explicit form. Conditional transfers are an implicit form of equalization that may, however, lead to greater entanglement of federal and provincial jurisdictions and to excessive uniformity. With explicit, unconditional equalization payments, the provinces have more latitude to respond to local preferences.

A strongly decentralized federation is not necessarily incompatible with a highly developed equalization system, since the provinces could assume responsibility for designing and financing equalization payments themselves.

Program Expenditures, by Level of Government, Canada, 1960-89



Constitutional options and transition costs

Regardless of the constitutional option eventually chosen in Canada, there will be far-reaching effects – some positive, some negative – on the way the economic union operates and on the well-being of Canadians. In economic terms, however, some options are more costly than others.

Indeed, the more radical the political changes, the higher the inherent transition costs and the higher the potential risks of uncoordinated action. One certainty is that the degree of unease felt by the public about constitutional change and the sensitivity of financial markets will be strongly influenced by the political climate prevailing before, during, and after the new structure is put into place. The costs of political change can be minimized – but not eliminated – if there is no escalation of tensions and if the process is orderly and takes place in an atmosphere marked by calm and mutual respect.

The Council acknowledges that its analysis of the various options inevitably leaves out many important aspects of constitutional issues – including some that are probably at the core of public debate, such as the preservation of a Canadian identity, the protection of culture and language, minority rights, political autonomy, and native land claims. However, these aspects fall outside the Council's mandate.

Constitutional options and economic impacts

Rather than try to assess all of the options proposed over the past few years by numerous task forces and parliamentary commissions, the Council selected a number of options that capture the range of possibilities. They are as follows:

1 the status quo;

2 moderate decentralization of federal responsibilities and functions;

Projected Government Revenues Required to Maintain the Same Levels of Government Expenditures under Various Constitutional Options, Canada, by Province, 1994-95



3 extensive decentralization;
4 a confederation of regions; and
5 sovereignty-association (where Quebec is assumed to sever all fiscal connections with Ottawa while the other nine provinces stay with the status quo).

These options must be assessed in the light of five types of costs and benefits: the impact on the economic union; dynamic gains; efficiency gains; transition costs; and the long-term impact on per capita income of a reorganization of taxes, transfers, and spending responsibilities in line with the new division of powers. It is this last impact where the Council has done unique in-depth analysis

Any change in the political structure will have an impact on the operation of the economic union. The more decentralization there is, the more difficult it is to keep the economic union operating efficiently. This problem can be offset if the federal and provincial governments agree on coordinating mechanisms.

Also, in the case of extensive decentralization, where substantial powers are devolved to the provinces, there is the potential for dynamic gains. These are the gains that come from greater social consensus and willingness to work together to solve economic issues.

Fiscal impacts

As well, the Council has also analysed the long-term impact caused by reorganizing taxes, transfers, and spending in line with the new divisions of powers. It has also studied the chain reaction that occurs when taxes and transfers are altered. The immediate effect shows up in disposable income, but this in turn changes the mix of goods and services consumed, produced, and traded across provinces.

One of the most important effects of the "moderate" decentralization scenario would be a decline in income in regions that are currently net recipients of federal transfers. The Atlantic region, British Columbia and the territories, for instance, would give up more in federal transfers for health care, education, and social welfare than they would gain from reduced federal taxes. Residents of these regions would see their standards of living decline by close to 2 per cent, while those of Ontario would see an increase of about 1 per cent.

The "extensive" decentralization model assumes that the provinces would take over responsibility for transfers to individuals (family allowances, unemployment insurance, grants to businesses, and so on). The magnitude of the impacts would increase dramatically. Declines in welfare in the Atlantic region, Saskatchewan, and Manitoba would range between 4 and 8 per cent. The Prairie provinces would find their fortunes deteriorating substantially because of a significant drop in agricultural subsidies, which have been particularly high in recent years. Under the extensive decentralization option, Quebec and Ontario would post significant gains. The federal government's powers in the area of taxes and transfers would be reduced to such an extent under this scenario that it would no longer be able to pursue its goal of equity among citizens. Its ability to act to stabilize the economy would also be impaired.

Under the confederation-of-regions option, all regions that formerly received equalization payments would see their situation deteriorate, while Ontario, Alberta, and British Columbia would see some improvement because of their lower federal tax burdens. The impact on the Atlantic provinces and the Prairie region would be devastating. The cost would be somewhere between 23 to 27 per cent in the Atlantic region. Manitoba and Saskatchewan would experience a 15-per-cent decline. The confederation-of-regions option would reduce the size of the federal government to about one fifth of total provincial expenditures in 1994-95.

Under the sovereignty-association scenario, Quebec would receive no federal transfers or equalization payments, and the federal government would stop buying goods and services from that province. But the trade and commercial ties with the rest of Canada would be

Economic Impact of Constitutional Options

	Decentralized federation		Confederation of regions	Sovereignty-association
	Moderate	Extensive		
Economic union	○	?	▭	▭
Dynamic gains	○	?	✣	✣ (Quebec)
Long-term impact of a new division of powers[1]				
Atlantic provinces	▭	▭▭	▭▭▭	○
Quebec	○	✣	▭	▭
Ontario	✣	✣	✣✣	○
Manitoba and Saskatchewan	▭	▭▭	▭▭▭	○
Alberta	○	▭	✣	○
British Columbia and territories	▭	▭	✣	○
Increased government efficiency	○	✣	✣	✣ (Quebec)
Transition costs				
Political risk	○	○	▭	▭
Default risk	○	○	▭	▭
Currency risk	○	▭	▭	▭
Debt-sharing and others	○	○	▭	▭
Treaties and others	○	○	▭	▭

Note ? Uncertain ✣ Benefit ▭ Cost ○ Insignificant

1 Reflects the impact of a reorganization of responsibilities in the areas of taxation, transfers, and government spending.

maintained. Under this scenario, Quebec would see the welfare of its residents fall by 1.5 to 3.5 per cent of provincial GNP.

Transition costs

The cost of re-confederation could be extremely high during the period of structural transition. And as noted earlier, the magnitude of these costs will primarily be a function of the social and political harmony prevailing during the period of constitutional change. Even in the best social and political climate, however, some transitional costs are inevitable.

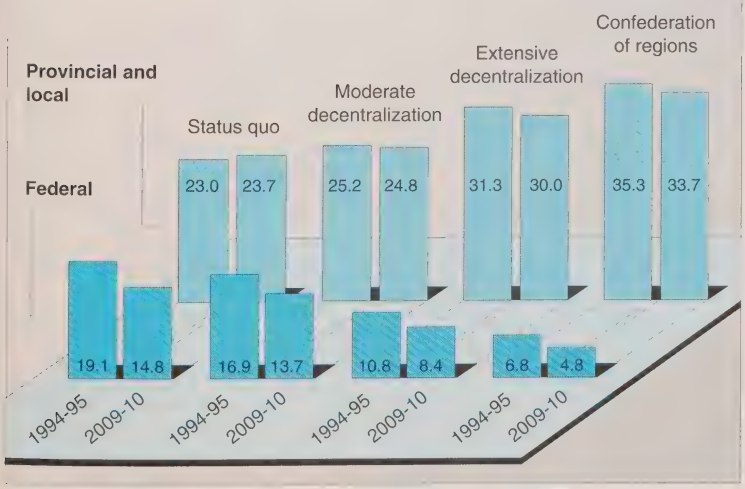
Risk premiums would probably rise under the sovereignty-association and confederation-of-regions options because the changes would affect important political institutions.

The sovereignty-association scenario assumes a division of the federal public debt and assets between Quebec and the rest of Canada. The confederation-of-regions option, too, might also require such an exercise, unless the regions decided to delegate responsibility for managing the public debt to the central authority.

This is a zero-sum game. Any gain by one party through a reduced debt share would represent a loss to the others through increased shares. Negotiations over how the debt is to be shared would be more difficult if carried out in a climate of conflict.

There are several ways that the transition costs and the costs associated with the division of assets and liabilities could be minimized. First, maintaining a common currency through a monetary union would avoid introducing any element of exchange risk into the financing of the debt. Second, it would be desirable to avoid redeeming existing debt and replacing it with new debt, by negotiating a phasing-in of the transfer. Third, the transfer of debt could be phased in over a period long enough to allow the development of new markets, so that the new securities could be issued without paying a premium over market interest rates. Finally, it might be advantageous to assign the responsibility for managing the debt to the federal government or to a special agency created for that purpose.

Projected Federal and Provincial/Local Government Spending under Four Constitutional Options, Canada, 1994-95 and 2009-10



Conclusion

The Council's analysis of the various factors involved in the constitutional options shows that any alteration to the fiscal and trade linkages has a bearing on the economic well-being of *all* provinces. In the short to medium term, the transition costs are significant. Even in the long run, the more radical options may entail a serious penalty in terms of higher real interest rates.

While some major adjustments would be required in order to make the status quo economically viable, the Council doubts that these changes would be enough to make that option politically acceptable to many Canadians at this point in the debate.

On the other hand, the confederation-of-regions option would place some provinces in such dire circumstances that the Council believes it must be excluded as a viable economic alternative.

The main concern with extensive decentralization is the negative impact it would have on provinces with lower fiscal capacity. They would likely have strong objections to this solution unless arrangements were made to strengthen the equalization system.

In the case of sovereignty-association or some other form of asymmetric arrangements, Quebec would bear most of the direct cost of changes to the tax and transfer systems but all provinces would be affected by the strains on the economic union.

Quebecers who expect large dynamic gains from that autonomy would also expect that citizens would benefit from long-run advantages. But again, the asymmetric federalism option can only be viable for Quebec and the other provinces as long as the question of political representation in central institutions is resolved. That, says the Council, is the major unknown in the asymmetric formula: how to build institutions that are accountable and where the allocation of voting rights is compatible with the aspirations and requirements of all the players.

All the provinces are members of the same economic system. This means that they would all share in the transition costs and in the cost of any failure to coordinate federal and provincial policies.

A fitful recovery

The economic recovery is under way – but it is fitful and shows signs of weakness.

There are indications that the economy is barely sputtering along, saddled with an unemployment rate of 10.2 per cent in September, consumer price inflation of 5.4 per cent, and about a 2-per-cent decline over last year in the volume of total output.

In its 28th Annual Review, the Economic Council notes that the most troubling aspect of the current situation is the persistence of the level of unemployment generated by the last recession. That recession – and perhaps the recession of the early 1980s as well – has left a deep mark on the economy.

On the surface, the rise in joblessness in 1990-91 seemed almost indistinguishable from that of 1981-82; in both cases, rates rose by 3.3 percentage points during the first 12 months of recession. But this similarity conceals some important differences. For example, the burden of unemployment in the 1981-82 recession was distributed fairly evenly between Quebec, Ontario, and British Columbia, whereas today, Ontario is bearing the brunt of the problem.

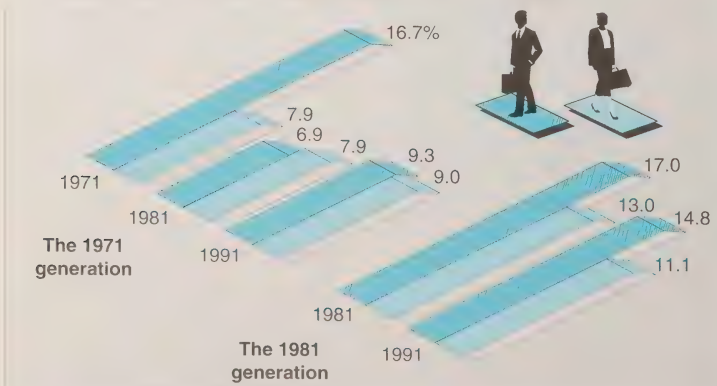
At the same time, the current plight of the jobless is cumulative in the sense that many younger workers, caught up in a cycle of short-term, seasonal, insecure jobs, may become trapped in the unemployment quagmire and find themselves unable to break away from it as they grow older. The Council views this as a profound social problem.

In the recession of the early 1980s, half the unemployed were under 24 years of age. In 1991, half of them are in the 25-44 age group. According to an analysis of unemployment data for the period 1971-89, 50 per cent of men claiming UI benefits in 1989 were doing so for the fifth time or more. Among women, dependency on unemployment insurance was much weaker. Only 30 per cent of women receiving UI benefits in 1989 were making a claim for the fifth time. On average, UI recipients who return to work experience another spell of joblessness once every three to four years and their second spell turns out to be longer than their first.

In light of these trends, the Council would like to see a more ambitious target for reducing unemployment.

In the past, government strategy has been, at least implicitly, to alternate between fighting inflation and fighting unemployment: first attack inflation for a certain length of time, then turn the attack to the resulting unemployment. The harmful effects of this strategy make it clear that the two goals should be given equal priority. New inflation-fighting methods must be found. To achieve this, monetary policy must be complemented by two other policy instruments – coordination of fiscal policies, and cooperation with business and labour leaders.

Unemployment Rate of Two Generations of Young Labour-Force Participants, Canada, 1971, 1981, and 1991



Some fundamental shifts

In part, Canada's current political and social difficulties stem from economic problems, including the federal debt and the country's inefficient industrial base.

There are two fundamental shifts that Canada must make in order to see improvements in living standards:

1 Canadian industry must restructure itself so as to produce higher-value-added products and to meet international competition head on; and

2 Canadians must adapt to a new economic policy regime focused jointly on curbing inflation, creating more jobs, and reducing the federal deficit.

The manufacturing sector accounts for the bulk of world trade, but Canada's productivity performance in this area is particularly disappointing. Not only has Canada been lagging further behind the United States since 1980, but it has been passed by West Germany, France, and Italy. Canadian hourly compensation is still high, and productivity performance remains low relative to the United States. Consequently, Canadian industries find it harder to compete.

The arrival of new players in the international arena – including Mexico, which seeks the creation of a North American free-trade area – the emergence of the newly industrialized countries of the Pacific Rim, and the inconclusive results of the Uruguay Round of GATT negotiations all point to the importance of enhancing Canada's competitiveness.

A shift is also occurring at the domestic policy level. Initiatives are focusing on deficit reduction and greater price stability.

This process poses a dilemma, however. Correcting fiscal imbalance is essential for the future health of the economy, but at the same time the remedial measures create political and social friction; for instance, substantial cuts in cash transfers to the provinces have had a direct impact on federal/provincial relations. And friction of this

kind impedes the ability of governments to tackle pressing short-term problems such as recessions.

The federal budget of February 1991 took steps to break the deadlock caused by inflation expectations, tight credit, and budget deficits. For the first time in many years, there is clear evidence of close coordination between federal fiscal and monetary policies.

Most of the provinces have adopted similar budget strategies, with the exception of Ontario, which in its last budget injected about $800 million of discretionary stimulus. At the end of fiscal year 1993-94 – two years after the anticipated end of the recession – the Ontario deficit will still stand at $8.4 billion. The net effect of the Ontario budget was to undo about one fourth of the contribution towards restraint made by the other provinces.

Overreliance on monetary policy to control inflation in recent years has had costly consequences. High interest rates have frustrated the government's efforts to reduce the deficit and have caused the Canadian dollar to rise in value. This, in turn, has diminished the competitiveness of Canadian exports.

The Council is pleased to see some encouraging initiatives in the area of cooperation, such as the new Labour Force Development Board. Several jurisdictions, including New Brunswick, Saskatchewan, Nova Scotia, and the Yukon, have agreed to establish parallel organizations.

Medium-term outlook and targets

According to the Council, as the economy recovers from recession it can grow at a rate of between 4 and 5 per cent during the 1992-95 period without jeopardizing prospects for a further decline in inflation rates. Once recovery is complete, a growth rate of 3 to 3.5 per cent is compatible with low inflation.

Over the medium term, the federal government's inflation targets of 3 per cent by 1992 and 2 per cent by 1995 appear to be attainable. However, the Council questions the appropriateness of an inflation target of less than 2 per cent after 1995. More research on the subject is necessary before setting long-range objectives of this kind, writes the Council.

These economic projections depend, however, on a number of domestic and international factors, including relative political stability in the Soviet Union and the Middle East, strong economic growth and low inflation in the United States, acceptance by both the public and private sectors of the proposed inflation targets, a gradual reduction in the borrowing requirements of the federal and provincial governments, and movement towards the resolution of constitutional issues.

ECC seminar program

The Economic Council periodically releases a list of its upcoming seminars, which are open to academicians, researchers from the public and private sectors, and interested members of the general public.

Below you will find the schedule of Council seminars (and guest speakers) planned for the next six months.

For more information about the seminar program please call (613) 952-1711.

Date	*Speaker*	*Topic*
December 11, 1991	Dr. Michael Wolfson Director General, Social and Economic Studies Statistics Canada	A Template for Health Information
January 15, 1992	Prof. David Laidler Department of Economics Univerity of Western Ontario	Price Stability and the Monetary Order
February 12, 1992	Prof. Lars Osberg Department of Economics Dalhousie University	Social and Economic Rights in a Constitutional Revision
March 11, 1992	Prof. Steven Globerman Department of Economics Simon Fraser University	Intra-Industry Trade
April 9, 1992	Prof. Pierre Fortin Centre de recherche sur les politiques économiques Université du Québec à Montréal	Persistence of Unemployment in Canada
May 20, 1992	Prof. Christopher Freeman Science Policy Research Unit (SPRU) University of Sussex (England)	The Future of Economics
June 15, 1992	Prof. Richard Lipsey Canadian Institute for Advanced Research (CIAR) Simon Fraser University	The Long-Term Determinants of Economic Growth in Advanced Countries

Mergers and acquisitions

Corporate takeovers and mergers have a tendency to grab the headlines in the economic sections of leading newspapers.

That is not surprising. In the eyes of many business people and observers, the size of a company is important: large is beautiful, because it suggests excellence and the ability to compete. The bigger the company, in this view, the more profitable it must be.

In a recently published study on acquisitions and mergers – the two main avenues for increasing company size – two researchers from the Economic Council, Abraham Tarasofsky and Ronald Corvari, challenge some of those clichés. Their main conclusion is that as a means of expanding operations, takeovers have little impact, on average, on the financial health of corporations.

The two economists analysed over 100 corporate takeovers and mergers in Canada during the period 1963-83. All of the companies involved were publicly traded on stock markets both before and after their acquisition.

The authors found that the average profitability of acquired firms as a group tended to remain unchanged after the transaction: about 40 per cent of them became more profitable, and an equal proportion saw their profitability deteriorate; the remaining companies showed no change. This was true regardless of whether the acquired company was Canadian- or foreign-owned.

Corporate takeovers, which first appeared at the beginning of this century, occur in cycles. As the authors point out, because of the sheer complexity of the subject and of the scarcity of data, great caution must be exercised in analysing mergers and acquisitions.

Profitability is only one criterion that can be used to gauge the economic effects of corporate takeovers. The two economists propose an ambitious research program that would identify other criteria, assess the economic impact of takeovers, and determine appropriate policy responses.

The many-sided corporate takeover

The corporate takeover is a multi-faceted activity and may be set in motion for a wide variety of often overlapping reasons. Once a company has decided to expand its operations through acquisition, it may proceed directly (by buying the assets of the targeted firm) or indirectly (by purchasing a controlling portion of its shares).

There are three types of acquisitions: horizontal, vertical, and conglomerate. In a horizontal acquisition, both the buyer and the acquired firm are in the same industry; in a vertical acquisition, one of the two parties to the transaction produces a good or service that is an input to the operations of the other; and in a conglomerate acquisition, the products of the firms are not directly related.

In all three cases, the firm that is planning to expand must ask itself whether it is more advantageous to acquire the assets and facilities of another than to expand its own operations. Similarly, the target company must determine what arguments will convince shareholders that they will benefit more from selling their shares than from maintaining the status quo.

Specialists have suggested a number of factors that may enhance the attractiveness of takeovers to either the acquiring and the target firms, or to both.

According to Tarasofsky and Corvari, the pre-takeover profitability of a firm is a key factor in the likelihood of its becoming involved in a merger or an acquisition. There is a 40-per-cent chance that "losers" and average performers will be takeover targets, whereas only 20 per cent of the more profitable "winner" corporations risk being targets.

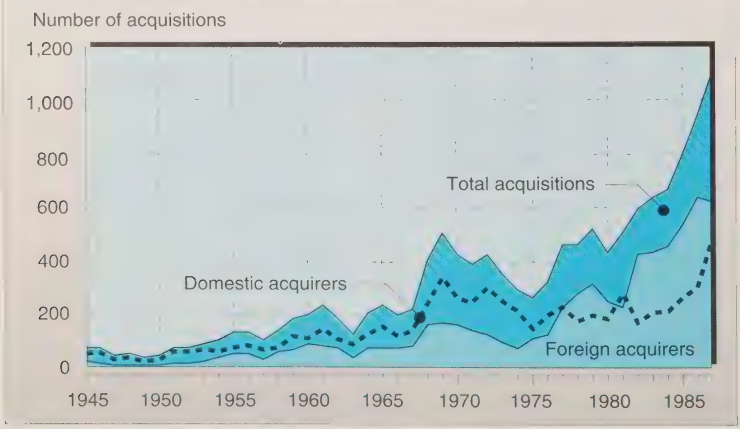
The outcome of takeovers also appears to be related to whether the acquired firm is a winner or a loser. Over half of loser corporations improved their profitability after being acquired – more than double the rate posted by winners. Conversely, well over half the winners saw their post-acquisition performance deteriorate, while only about one third of losers had the same experience. The results were more evenly distributed in the large category of average performers, with negative results outweighing positive outcomes.

The reasons a firm decides to expand by acquiring another boil down to one overriding goal: the new owners want to increase profits.

Rather than compare corporate takeovers and mergers to a marriage, the authors suggest that they should more appropriately be viewed as transactions between two parties, one of which immediately ceases to be a separate entity while the other undertakes to create a third party whose success will determine that of the whole venture.

According to Tarasofsky and Corvari, the main impression emerging from a comparison of the pre- and post-

Domestic and Foreign Acquisitions in Canada, 1945-87



acquisition profitability of firms as a group is one of motion without movement – certainly without progress – no matter what measurement techniques are used: when a Canadian company is acquired by another firm, it has only about two chances in five of seeing its profitability improve and is just as likely to see it decline.

Managers and shareholders

Overall, these results are of great interest from several points of view. They show, for example, that managers are often the first to pack their bags and leave after their firm is acquired by another. As for the shareholders, although they are indispensable to the process, they tend to remain passive and acquiesce in the proposed transaction. Since it is their assets that are at stake, they should understand that a takeover bid, although invariably presented to them as being in their interests, is just as likely to leave them worse off as better off.

The managers of target firms are often no more than bystanders to the entire takeover process, unless they are themselves shareholders. Not surprisingly, some of them are left wondering how they will fit into the new "ménage."

The authors also note that the organizational dynamics associated with acquisitions have been largely neglected by both economists and scholars in other disciplines and that much of the available evidence on this subject is anecdotal.

Problems

Acquisitions typically involve firms that are far apart geographically, and this may give rise to problems. For example, an acquisition may have the curiously perverse effect of increasing both the job security and the frustration levels of incumbent managers. Enjoying perhaps less autonomy than before, they must now follow the dictates of a new management team whose "feel" for the local situation may be, at least for a time, superficial or even deficient.

If the incumbent managers are replaced by a new team, the latter may find itself faced with a good deal of suspicion or even hostility from subordinates who had grown accustomed to working with the previous team.

Sometimes, the new owners insist on forcing the acquired firm into a straitjacket to make it conform to some preconceived notion. However, this may result in discarding the benefits of many years of hard work by the firm's previous management. If the new managers arrogantly reject any possibility of alternative approaches, they may end up losing more than they gain. And yet, the higher the price of the takeover, the greater the likelihood that control will be tight and uncompromising. At the same time, the former managers are unlikely to be inclined to roll out the red carpet for the new "bosses" sent by the acquiring firm.

The two authors also note that the managers of acquiring companies are sometimes more concerned with increasing corporate size – and their own "empire" – than with improving profits, as the shareholders would probably prefer. This may give rise to differences of views with the existing managers.

A limited phenomenon in Canada

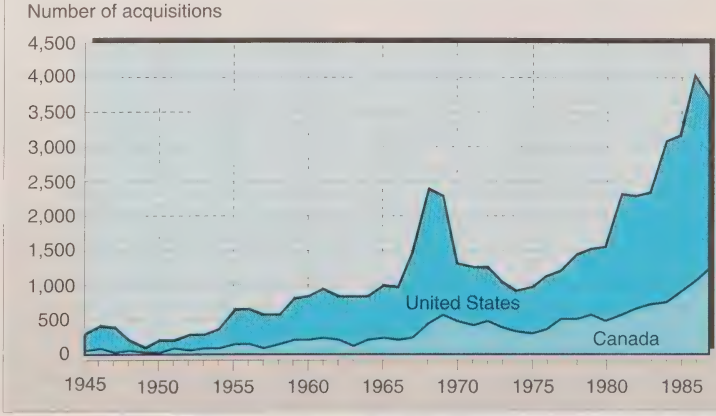
The proportion of takeover candidates is smaller in Canada than in some countries with a comparable degree of development – the United States, for example. The shares of traded corporations are probably less widely held in this country than in the United States.

Operating under the eyes of fewer but more observant shareholders, Canadian managers may be more protective of shareholder interests and may be less likely to embark on ill-advised acquisition projects or succumb to the temptations of empire-building. Canadian managers are generally more cautious.

Tarasofsky and Corvari discuss the course that government should follow, given the finding that takeovers are not a particularly promising way for firms to expand and the fact that government can no more force corporate managers to act prudently and wisely than it can legislate morality.

The authors suggest that governments can still take action to ensure that shareholders are well informed about what is going on in the industry. For example, they could pass legislation forcing management to provide more complete information on acquired subsidiaries.

Acquisition Activity in Canada and the United States, 1945-87



The business of Prairie farming

Ken Stickland has been a member of the Economic Council since 1987. As a farmer and agricultural adviser, Mr. Stickland is familiar with the important challenges facing today's Prairie farmers. In particular, he is knowledgeable about the government's various agricultural assistance programs. *Au Courant* recently had the opportunity to interview Mr. Stickland.

Au Courant: Being in the consulting business, are you still managing your family farm?

Stickland: I spend about 95 per cent of my time in the Edmonton consulting firm, including 30 per cent on many farm-level marketing decisions with different family farm operations all across Alberta. Our Red Deer grain farm is one of my larger customers and gets help about every two weeks plus one to five days of physical work during most harvests.

Au Courant: As a consultant, how do you interact with your farmer clientele?

Stickland: I speak at agricultural conferences and run three strategic planning seminars each year in five locations. I communicate with them weekly by recorded telephone message and respond to their individual phone enquiries. When on their farms, we talk not only about economics but also about human relations and other factors involved in farm decisions. Farming is a pretty complex and intriguing family business. One of our objectives is to encourage the full participation of the family members, particularly farm women.

We discuss the economic, political, biological and weather signals as to what to grow and when to put the crops on the market in the most advantageous way. We try to remain focused and strategic, regardless of whether our assistance is in individual consulting, seminars, a newsletter or through software. For example, we sell and train farm families to use FMS – farm financial management software – to plan, record and evaluate all enterprises on and off the farm.

Au Courant: Does that mean that most farmers use a personal computer?

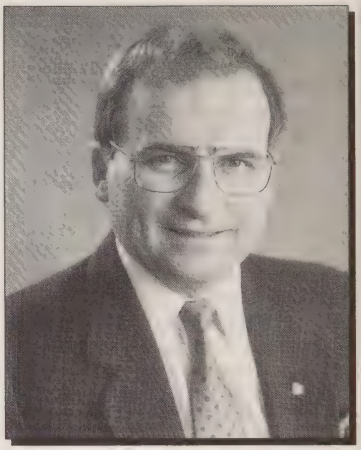
Stickland: Oh no. Whereas 40 to 50 per cent of small businesses in urban areas would have computers, agriculture lags behind, with only about 15 per cent of farmers having one. Effective computer use for management purposes is limited mostly to specialized or larger farms or to advisors; but the GST and the need for bookkeeping for programs such as the Gross Revenue Insurance Plan (GRIP) and the Net Income Stabilization Account (NISA) should accelerate the adoption of computers.

Au Courant: How do the latest government programs differ from the traditional farm commodity programs?

Stickland: There was a major shift in 1991, the biggest since the formation of the Wheat Board in 1935. Essentially, it's a movement away from the "collective" Western Grain Stabilization Act (WGSA) system to an "individual" insurance mechanism that protects against fluctuations in grain incomes. In that sense, we've moved towards the American style of farm programs. Under GRIP, for example, assured target revenues vary between farmers because of crop mix, crop insurance, yield experience, and program options. This calls for individual decision making.

We have developed spreadsheets and we provide regular predictions of the impact of the government program to make sure that the control of the farm remains with the farmer and that he is not blindly influenced by perceptions and "coffee-shop" decision making. Farmers are very independent people. Sometimes government programs become the big determinant, but as an independent consulting firm, we help the family to retain control.

In the past, a lot of farmers weren't buying crop insurance. They probably didn't think it was appropriate, didn't understand it, or didn't feel the need for protection. So this spring government came along, not with hail or weather protection, but with price/income



Ken Stickland

protection. Would the farmers, who had rejected crop insurance, opt for the new price/income insurance? It was a real struggle, and I think the Economic Council can take some credit for its recommendations in 1988 that farmers should show some risk management initiative if they expect public help during extreme times.

What's curious is that I'm sure that if farmers and the Council had been in charge of these programs, GRIP and NISA would have been introduced in reverse order, NISA first and GRIP second. GRIP came out first when it appeared that GATT was going to fail. With the prospect of a greater farm income problem, the government next responded with the NISA proposal. NISA is broader than GRIP, it's more flexible and it's almost to the letter what the Council had proposed in 1988 as an income stabilization fund, a saving mechanism.

Au Courant: What was the community's reaction at that time?

Stickland: What was fascinating for me as a Council member was to hear the arguments of professional, university and other researchers, on the 1988 Agricultural Advisory Committee (which the Council formed to assist its research team) discuss the document then see it go through a full Council and now witness some of its policies be

implemented three years later. I saw the willingness of business and taxpayers to help agriculture, subject to specific guidelines. I then saw the agricultural community go through an intensive policy review in 1990, followed by a Farm Income Protection Act, implementation of the GRIP and NISA programs, and then the outcome. The government had to sell its program, so it made a pay-out during the first year. It's as if you had bought fire insurance knowing that you were going to get a payout the first year.

The controversy about the GRIP program in the West was about two or three times as intensive as the debate in the East. It is a relatively good program. Some economists criticized it, claiming that GRIP would encourage wheat production and aggravate the adjustment out of glutted grain markets. Those February 1991 criticisms got the debate going when farmers should have focused on understanding GRIP and made a yes/no decision. A lot of farmers got lost in that debate, delaying their entry until May, when they joined like lemmings.

Au Courant: Did you have any problems with the GRIP program?

Stickland: The major drawback is that GRIP uses a 15-year moving average in order to raise the level of support high enough for Saskatchewan. You will recall that the Council was recommending about a five-year moving average of income, but GRIP is based on a 15-year moving average of grain prices. I think that 15 years is too long. Structural shifts have moved the price of wheat lower than the 15-year average. Setting it so high will favour wheat over livestock production to a certain extent. The preoccupation with the GRIP decision may have inhibited farmers from planting forages and barley.

Yet the government was aware of some of the program's problems. By April, it announced some fine tuning. More money was made available to farmers for planting grass as permanent cover on erosion-sensitive land. Furthermore, when you work at the farm level, as I do, you just don't let a farm program stop clients from diversifying. You look at any program as support along the way to a more world-competitive farm. So we counselled adding grass or pea acres, even if there was a lower GRIP target revenue. Good farmers are looking for the sum of all the factors – for the optimum situation – and surely the market is saying, "get diversified." Governments try their best and send us signals, then good managers and their advisers apply some common sense about what's good for the long run.

A serious drawback with GRIP is the delay in payout, which is affecting cash flow. Three payments are anticipated after harvest in November, in June 1992, and then in January 1993. Angry rallies this fall are mostly about the timing of GRIP help, not the magnitude.

Au Courant: NISA is the farm program that is closer to the Council proposal?

Stickland: Exactly. Part of the Council's objective was to encourage asset diversification. Instead of putting profits into more land during good times, under NISA farmers can put it into bonds and then during bad times they'll have access to cash to cover the downside risk. Farmers loved NISA. In Alberta, farmers kept saying, "I wish the NISA program was here because I would join that right away but I'm not so sure about this GRIP program." That increased the farmers' frustration. It would have been more appropriate for NISA to come first and for GRIP to come later. But the federal government couldn't get the provinces to agree, so GRIP came first and NISA last.

Au Courant: Is there any way of switching from GRIP to NISA?

Stickland: Yes, but slowly. Once the grain farmer signs up for GRIP, he must stay in it for four years. Now that NISA is available, more farmers will probably plan this spring to give notice of intention to leave GRIP while continuing their inputs to NISA.

There has been some loss of freedom by the farmers who joined GRIP. But from a taxpayer's perspective, from a local businessman's perspective, GRIP makes a major contribution to lowering risk; and, remember, the title of the Council's report was *Handling the Risk*. GRIP only covers prices up to 70 per cent of the 15-year indexed moving average, so you still have a 30-per-cent unprotected swing. That is more risk than most urban businesses are subjected to, but clear-thinking farmers are saying, "GRIP makes the farm business a bit more reasonable."

Au Courant: Do these farm programs favour the smaller or larger farms more than the earlier farm programs?

Stickland: There is no limit on the size of payout under GRIP, and there are going to be some large cheques. Effectively, then, the medium-sized and larger farms get more from GRIP. The concerns of the Council, therefore, were not met by GRIP but they were met by NISA. The government sets a limit on the maximum pay into NISA (and hence payout). NISA also has a low-income trigger, similar to what the Council proposed.

Au Courant: If farmers should switch from GRIP to NISA over the longer run, how do you think it will affect the exit of farmers from agriculture and the size of farming communities?

Stickland: A good question! In the short run, GRIP will provide considerable stability to farmers and the rural communities, but that comes at the cost of continued unrealistic upward pressure on land prices and rents. Within three to four years, GRIP's bias towards wheat will be less. Providing NISA is broadened to include livestock, it will probably have a positive effect on diversification and hence on rural employment. NISA may affect the small towns more than other government programs did in the past; it should encourage liquidity, enabling farmers to be more entrepreneurial and to invest in municipal bonds or other financial instruments, or perhaps in hometown business. So NISA should make a positive contribution to rural development over the longer term.
(See *Handling the Risk*, ECC 1988)

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Twenty-Eighth Annual Review

A Joint Venture – The Economics of Constitutional Options (EC21-1/1991E; $12.95 in Canada; US$15.55 outside Canada).

The Economic Council is devoting its Annual Review this year to an analysis of the important economic issues arising out of the current constitutional debate. The Review assesses the nature of the economic linkages among the provinces and argues that we need to reinforce the Canadian economic union. The Review also investigates the fiscal relationships between the provinces and the federal government and debates some of the key issues of the day in that area. Options for reforms are highlighted and related to different visions that Canadians may hold with respect to equity. The last part of the book is devoted to a qualitative and quantitative assessment of some of the costs and benefits attached to various political models that could emerge from the current constitutional debate, including sovereignty-association. As usual the Review presents an analysis of current economic conditions and a medium-term economic outlook for the Canadian economy.

Annual Report

The Economic Council's Annual Report for 1990-91 is now available. It includes a message from chairman Judith Maxwell, as well as a description of the role of the Council. It also details Council activities and research projects currently under way. For a free copy, contact Publication Division (address below).

Studies

Income Maintenance, Work Effort, and the Canadian Mincome Experiment (EC22-174/1991E; $12.95 in Canada; US$15.55 outside Canada).

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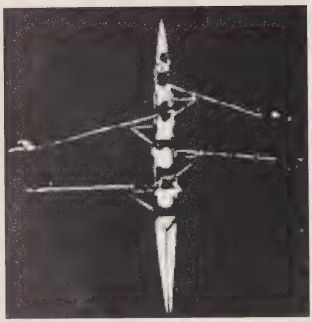
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- Competitiveness and the public sector

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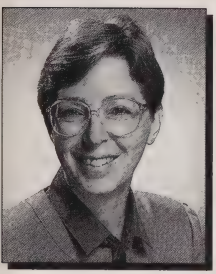
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The Economic Council closes



Judith Maxwell

The federal government announced in its recent budget that the Economic Council of Canada will be closed. That decision was part of a package of budget cuts aimed at reducing federal expenditures.

Once we got over the surprise, we immediately put in place measures to lessen the impact of this decision on the Council's employees by giving them as much help as possible in their search for new jobs. At the same time, we took steps to ensure that certain major research projects will be completed. The consensus statement *Pulling Together*, featured in this issue of *Au Courant*, is therefore not the final Council publication.

Two other documents that were nearly completed at the time the closing was announced, will be published in coming weeks. One is on Education and Training and the other on Poverty Dynamics. Both will provide powerful insights into the issues we face in the difficult environment of the 1990s. Both bear witness to the Council's 28 years of excellence in research, consensus building and communication with Canadians.

The Economic Council of Canada was created in the 1960s because, at that time, the federal government wanted to bring together business, labour, consumers, farmers and others, to give momentum to a new research organization focused on the medium- to long- term issues facing the country.

The *First Annual Review*, published in December 1964 set out economic goals for Canada to 1970. It included a chapter on the significant factors in economic growth and pointed to the importance of resources, technological change, R&D, and skilled manpower – the very themes in *Pulling Together*.

Pulling together

Pulling Together was hailed by Henri-Paul Rousseau of the National Bank as a major contribution to our understanding of the economic developments that have occurred over the past two decades.

The report confirms what many have felt in their pocketbooks – the good old days were very good indeed. In the 1960s, incomes were growing so fast that a typical Canadian could expect his or her real income to double in 18 years. Today it would take 35 years.

The Council explains what went wrong, by comparing Canadian industries to their foreign competitors – looking at productivity, costs, innovation and trade.

We discovered that the problem is us. Canadians tend to resist change. We avoid competition. We try to protect our way of life from what is happening in the global economy. Instead, we need to embrace change, adapt to the new ways of producing, trading, and managing our economy. That will be the best way to protect what is important in the Canadian way of life – a high standard of living, a strong sense of sharing, and tolerance for each other.

We can see some encouraging examples of the new mindset – in management, in labour and in governments. Management and labour are learning to cooperate, governments are finding ways to be more effective and efficient, and there are examples of public-private sector cooperation. But we need more than examples, we need everybody on the new wavelength – pulling together.

Canada faces grave difficulties in both manufacturing and resources. In the natural resource industries, firms face weak prices and relatively slow growing markets. World demand is shifting towards manufactured goods, especially high-tech ones.

In manufacturing, productivity – output per unit of input – has slowed in the 1980s, while it picked up in other countries. Costs of producing an average unit soared in the 1980s, partly because higher rates of inflation have become embedded in our cost structure, and partly because of slower productivity growth in trade-sensitive industries. As Canadian costs soared, customers turned to other suppliers. (Even consumers began to do more shopping across the border.) Sales by Canadian plants slumped, production was cut and workers were laid off. These trends were quite evident before the recession began in early 1990 and they have made that recession particularly painful in Ontario and Quebec.

The Council points out that there is no easy way to overcome this cost disadvantage – just as there is no easy way to shed 40 pounds of excess weight. We need to see changes in the way companies are managed, in labour management relations and in the signals governments give when they intervene in the economy. In general, we have a problem. And, in general, we must pull together to solve that problem.

Over the years, the Council has published pathbreaking research and put forward policy proposals which have helped to shape the public policy debate. That research has in turn been reported in the pages of *Au Courant*.

This will be the last issue. But our work will live on in our books, even as we sadly close the doors. If you would like to receive a free summary of the two forthcoming reports on education and training on poverty dynamics, please write to the Council and we will put you on our last mailing lists.

Good-bye and good wishes from all of us at the Council.

Canadian standards of living

A serious challenge

Rich in both human and natural resources, Canada belongs to a select group of countries whose citizens enjoy the highest standards of living in the world. With its advanced communications and transportation networks, a large and mature education system, a high-quality health care system, a broad social safety net for those in need, and extensive trade linkages with the United States and other industrialized countries, Canada is an economic success story, a country that offers its citizens a quality of life that is the envy of many.

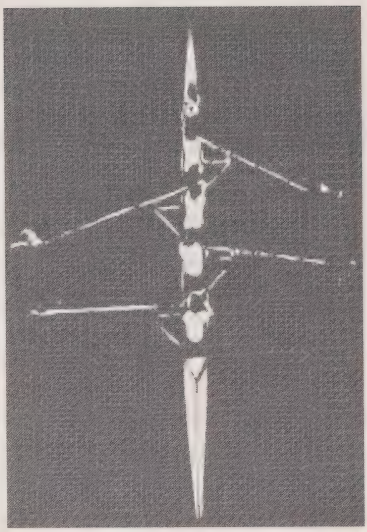
And yet the economic stresses of the 1980s have revealed the fragile nature of past successes. Real wages, which are inextricably linked to productivity growth, have improved little over the past decade or more. Given present productivity growth rates, Canadians will need 35 years to double their real incomes (i.e., after inflation). In the 1960s, they could do it in less than 18 years. Overall, economic prospects are simply less promising than they used to be.

What has happened? Why is the future less certain than it once was? Why is productivity growth slowing down?

In a Statement entitled *Pulling Together*, the Economic Council assesses Canada's ability to maintain and improve the current high standards of living enjoyed by its citizens. It examines the various factors affecting the country's ability to compete and attempts to find solutions to the difficulties threatening Canadians' future improvements in living standards. Why is Canada facing so many problems? What can be done about them?

In trying to answer these questions, the Council examined how the world economy is changing and how Canadians have reacted to these transformations. More specifically, Council researchers evaluated Canada's competitive position and studied the structural changes taking place in the global economy. They tried to find out why Canadian industry has performed so poorly over the past 20 years, and why Canada's performance has deteriorated relative to that of its major trading partners.

The Council's Statement examines Canadian competitiveness from four main points of view: productivity, trade, innovation, and production costs.



Globalization and the Canadian economy

Much of the economic uncertainty that Canadians face finds its roots in the speed of change in the global market. Driven by a veritable technological revolution, systems of financing, production, and marketing at the local, regional, and national levels have become more and more closely interlinked in a worldwide network. Nowhere is the changing nature of international trade more evident than in the strong push for trade liberalization, with the expansion of the European Community, the dismantling of trade barriers between the Community and the European Free Trade Area, the Canada-US Free-Trade Agreement, and the current talks between Mexico, the United States and Canada.

These new trends in the global economy are exerting strong pressure on Canada. The effects are evident on jobs, wages, and profits. After rising very rapidly – about 4 per cent a year – during the 1960s and early 1970s, the growth rate of Canadians' real income decreased to about 2 per cent a year in the last decade.

Concern about incomes has surfaced in the national debate on Canada's international competitiveness. Concern about competitiveness has been further magnified by the job losses associated with the recession that began in 1990. The migration of some Canadian firms to the United States has added fuel to the fire.

The problems in the manufacturing sector and the decline in Canadian competitiveness have been attributed by some to the Canada-U.S. free-trade agreement and the introduction of the goods and services tax (GST).

That explanation is not persuasive, however, because it focuses on relatively recent trends. The cost position of Canadian manufacturing has been deteriorating over a period of several years; it did not suddenly appear two or three years ago. In 1980, for example, unit labour costs in manufacturing were virtually the same in Canada as in the United States. By 1990, however, Canadian costs were about 40 per cent higher than U.S. costs. This deteriorating cost performance, coupled with shortcomings in the innovation process, is a clear result of the slowness with which Canadians have reacted to changes in the economic environment over the past decade and a half.

Canadians' aversion to change shows up in all the lines of research pursued by the Council. It is evident in poor productivity growth. It is also evident in the country's export pattern, in its persistent reliance on natural resources an resource-based products, in its lag with respect to the innovation process, and in the apparent inability of business, labour, and government to coordinate their efforts when the need arises.

The Council's work shows conclusively that the problems facing Canadians are systemic: they are rooted in the attitudes of decision makers in all sectors of the economy and at all levels of management and production.

These findings are important, for there is no escaping the fact that the ultimate source of growth in real incomes is increased productivity – that is, the ability to produce more from the same amount of capital, labour, and raw materials. Productivity growth can also generate funds that Canada can use to clean the environment, improve health and education, and provide better economic security for the poor and the unemployed.

A key factor

Productivity growth

The goal of improving Canadians' real incomes (and so their standards of living) depends on a key factor: productivity growth. Unfortunately, over the past 20 years the pace of productivity growth has slowed markedly in Canada. This is cause for great concern.

If productivity growth in Canada in 1974-90 had continued at the same average rate as in the preceding decades, Canadians' incomes would be 24 per cent higher (i.e., by about $6,100 per person) than they are now. Over the past 45 years, the wages of Canadian workers, adjusted for price changes, have generally matched the pace of productivity growth.

The facts speak for themselves. Since the 1973 oil-price shock, aggregate labour productivity in Canada has grown by only 1.2 per cent a year, compared with an annual rate of 2.4 per cent from 1962 to 1973. While these difficulties have been shared by all industrialized countries, most have recorded more rapid productivity growth than Canada over the past decade. The manufacturing sector is a source of particular concern because its relative productivity and cost performance will have the greatest impact on Canada's ability to meet successfully the growing competitive challenge from other nations. In terms of productivity growth, Canada lags behind the other major industrialized countries. Indeed, the gap relative to the United States, Canada's biggest trading partner, widened considerably during the 1980s.

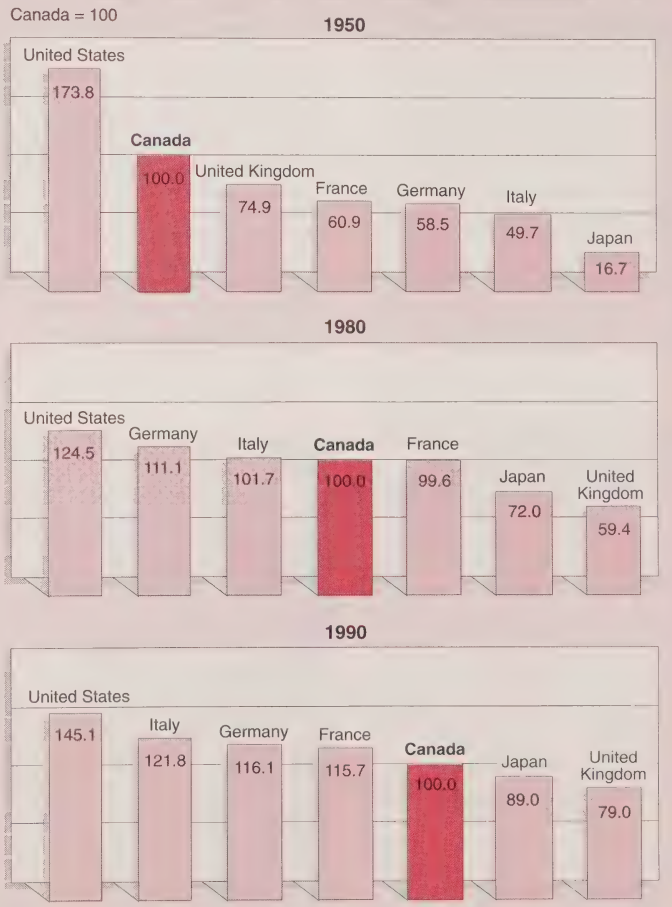
Canada has substantially improved its overall levels of labour productivity (measured as real GDP per worker) and real per-capita income relative to the United States. In 1950, U.S. productivity was 32 per cent greater than Canada's. Today the two countries have virtually identical productivity and income levels.

The picture is less rosy in the manufacturing sector, however. The gap between Canada and the United States, which narrowed substantially during the period 1950-80, grew rapidly in the 1980s. Canada had reduced its productivity gap with the United States to 24 per cent by 1980, but over the next ten years the gap widened again to 45 per cent, roughly where it was in1960.

Canadian manufacturing industries are losing ground not only to their U.S. counterparts, but also to those in the other major industrialized countries. For example, the productivity levels recorded in West Germany, France and Italy had reached or surpassed the Canadian level by 1980. And they have continued to gain ground since then. Manufacturing productivity in Japan now stands at almost 90 per cent of the Canadian level, up from about 53 per cent in 1970. The newly industrialized countries of the Pacific Rim – notably, Hong Kong, Singapore, Taiwan, and South Korea – have also dramatically improved their productivity relative to Canada.

It is interesting to note that foreign-controlled firms account for about 50 per cent of total sales and employment in the Canadian manufacturing sector. The labour productivity level of these firms

Productivity levels in manufacturing, G-7 countries, 1950, 1980, and 1990



was, on average, 20 per cent higher than that of Canadian-controlled establishments during the period 1985-88. The productivity gap between these two types of establishments tends to be largest in industries that are heavily protected by tariff and non-tariff barriers.

Why the slowdown occurred

While the productivity slowdown has been extensively studied, researchers have been unable to agree on its precise causes.

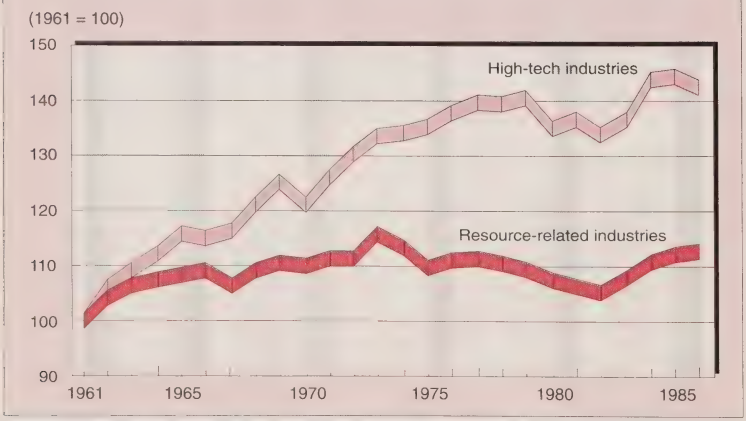
The Council's research suggests four interrelated factors as being among the most likely culprits: weak demand conditions, adverse interindustry shifts, a lower rate of substitution of other inputs for labour and sharp increases in real energy prices. The first three factors are closely related one to another, while the fourth – the energy price shocks – was the trigger that set the slowdown in motion.

Overall, 30 per cent of the slowdown in productivity growth may be attributed to these energy-price shocks. In the manufacturing sector alone, skyrocketing real energy prices were responsible for about 60 per cent of the slowdown in labour productivity growth between 1966-73 and 1974-85.

The impact of these shocks was amplified by a worldwide shift to very tight monetary policies in response to higher rates of inflation. These developments had a negative impact on capacity utilization in Canada and other countries, particularly in sectors such as mining, public utilities, transportation, storage, communications, wholesale and retail sales, and services to business. The decline in capacity utilization, in turn, was a major factor in the productivity slowdown.

During the 1950s and 1960s, capital and labour tended to shift from agriculture to more productive sectors like manufacturing. This contributed to a significant increase in Canada's overall productivity. From 1966 to 1973, transfers of this kind had only a limited impact. In the period 1974-85, however, resources began to move from high-productivity goods-producing industries to service-sector industries where productivity growth rates are generally lower. This development alone can be held responsible for a drop of about 20 per cent in the rate of Canadian productivity growth in both the 1966-73 and 1974-85 periods.

Change in productivity, Canada, 1961-86



The Council's report also notes that policies intended to help Canadians to cope with the oil shock and to shield them from a slowdown in real incomes ended up holding back the process of economic adjustment and the development of conditions for strong, stable, and noninflationary growth.

According to the Council, Canada's inability to close the productivity gap with the United States after 1973 may be largely attributed to five factors: 1) the oil-price shocks had a more severe impact on productivity in Canada than in the United States during the 1980-85 period; 2) the marked appreciation of the U.S. dollar triggered a rationalization effect in manufacturing, which had a positive impact on productivity growth in the United States; 3) U.S. industries invested much more in innovation than did their Canadian counterparts; 4) the rate of substitution of capital and other intermediate inputs for labour was much higher in U.S. industries; and 5) the shift from low-productivity to high-productivity resource-based industries was smaller in Canada than in the United States.

Thus if there is one lesson to be learned from the post-1973 experience, it is that economies must be more flexible in the face of a relative-price shock or of other external developments. Flexibility is the key to improving the inflation/growth trade-off and – ultimately – the necessary conditions for productivity growth.

"Unless adjustment to economic shocks occurs more quickly and more firmly in the future, the prospects for a substantial increase in productivity growth are likely to remain poor," states the report.

However, the Council also notes a number of positive signs that point to eventual improvements in productivity and real incomes. Among them are the fall in real energy prices, the slowdown in the growth of the working-age population (a trend that encourages greater use of capital inputs), and the structural reforms associated with the Canada-U.S. Free-Trade Agreement and the implementation of the goods and services tax.

Trade

The challenge of remaining competitive

Because of its relatively small domestic market, Canada relies heavily on international trade. For instance, it exports around 28 per cent of the goods and services it produces and imports a similar proportion of what it consumes.

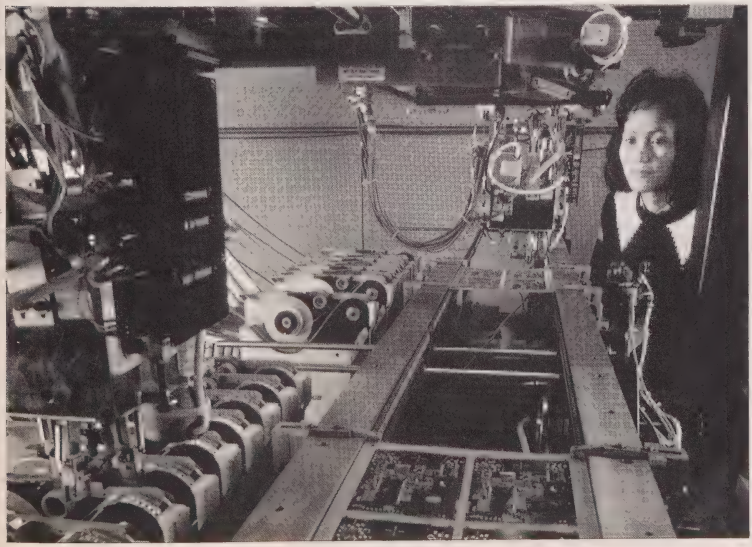
As a result, it is vital for Canada to maintain and expand its access to world markets, as well as its ability to compete in terms of price, quality, service, and new products. Trade and its associated competitive pressures are also important because they encourage businesses to rationalize their operations, to introduce better management practices, and to adopt and promote state-of-the-art technologies. And in the end, trade with other members of the international community helps to boost productivity and increase workers' real incomes.

The rapid growth of international trade is one of the most important economic developments of the past 20 years. A number of trends have emerged during this period. For example, the weight of North America in world markets has declined modestly, from 19 per cent in 1971 to 17 per cent in 1989. This decline does not mean that North American exports have fallen, however; rather, it reflects the meteoric rise of countries in the Asia/Pacific region – Japan, Hong Kong, Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, the Philippines, China, Australia, and New Zealand. These countries saw their share of world exports jump from 13 per cent in 1971 to almost 25 per cent in 1989.

The United States has long been, and remains, by far Canada's most important trading partner. U.S. customers purchase almost 75 per cent of Canadian exports. In recent years, however, Canadian trade with the Asia/Pacific countries has expanded significantly, and collectively these countries now represent a more important export market for Canada than the European Community.

Canada's share of world trade fell from 5.3 per cent in 1971 to 4.0 per cent in 1989. What factors are behind this decline? To answer these questions, Council researchers disaggregated Canada's share of world exports into three components: its product/industry composition, its geographical distribution, and a third factor referred to as "Canada's ability to compete in foreign markets."

A country may gain or lose shares of world exports according to whether its exports are concentrated in products for which world demand is growing relatively quickly or relatively slowly. That could also happen if its exports are destined for markets that are relatively more or less dynamic than the world average. The Council's research in this area indicates that the overall loss in Canada's share can be largely attributed to a deterioration in its "ability to compete." That development was not only the result of the inevitable gains in market share achieved by countries with much lower costs – China and the newly industrialized countries (NICs) of Asia, for example – but also of a number of domestic factors that eroded Canada's cost structure relative to the United States.



Industry, Science and Technology Canada

Canada's comparative advantage

Over the longer term, a nation tends to specialize in products and services that it produces *relatively* more efficiently than its trading partners. In other words, it offers products and services that reflect its "comparative advantage."

The Council's analysis of the composition of Canadian exports in relation to trends in world trade reveals that they are concentrated in resource-based products such as pulp and paper, wood products, nonferrous metals, chemical products, fertilizers, and so on.

A comparison of Canada's position with that of the other large industrialized countries or the Asian NICs shows that these other countries generally have a broader range of comparative advantage in the manufacturing sector than Canada. The contrast is even more striking when the automotive sector is excluded from the data. Canada's concentration on resource exports places it in a group that includes Sweden, Australia, and New Zealand, although Sweden has a more diversified export structure.

What's more, Canada's comparative advantages have changed little over the past 20 years. The other members of the Group of Seven – the United States, Japan, Germany, France, Italy and the United Kingdom – have comparative advantage structures that are more closely aligned with the changing pattern of demand on world markets.

Canadians, the Council stresses, may find it hard to sustain the relatively high living standards to which they are accustomed if they do not free themselves from their current dependence on the natural-resource sector. At the very

least, some major improvements in the performance of that sector will be necessary.

At least four factors are behind the problems in the primary sector. First, not only are products in this sector becoming progressively less important in world trade, but the share of resource-processing industries in manufacturing trade is also declining. Second, the relative prices of resource commodities have been falling over the past two decades. Third, productivity in the natural-resource processing industries has grown, on average, at a significantly slower pace than in the other manufacturing industries. Fourth, environmentally conscious consumers are concerned about the pollution caused by industries based on resource extraction and processing.

This situation must be turned around. To do so, says the Council, Canada must commit itself to the following changes:

- a general increase in productivity growth relative to other industrialized countries;
- shifts to higher-productivity activities within the resource sector; and
- the development of new areas of specialization.

Cost performance in manufacturing

In the short to medium term, a change in a country's relative cost position affects the volume of its exports and imports. This inevitably affects output, employment, and capacity utilization in sectors linked to international trade.

While Canada's cost position vis-à-vis West Germany, Japan, Taiwan, and South Korea improved during the decade, the same cannot be said with respect to the United States. In 1980, the manufacturing costs were only 2 per cent higher than south of the border. By 1990, the gap had widened to 40 per cent. This is serious because, as mentioned earlier, most of Canada's manufactured trade is with the United States.

Slower productivity growth and higher inflation can account for virtually all of the rapidly widening gap between the two countries. During the 1980s, total nominal hourly compensation (including payroll taxes) in Canadian manufacturing increased at an average rate of 6.5 per cent per year, compared with 4.7 per cent in the United States. Yet Canadian productivity growth during this period was slower than in the United States.

It is important to realize that the growth in hourly compensation in manufacturing was not primarily a cause of inflation, but rather a response to it. Still, it did contribute to the deterioration in Canada's unit costs relative to the United States.

In the U.S. manufacturing sector, real wages dropped even though productivity was improving. In Canada, real wages rose even though productivity improvements in this country were more modest than in the United States. The inevitable result was the erosion of Canadian markets and the loss of many jobs in this country.

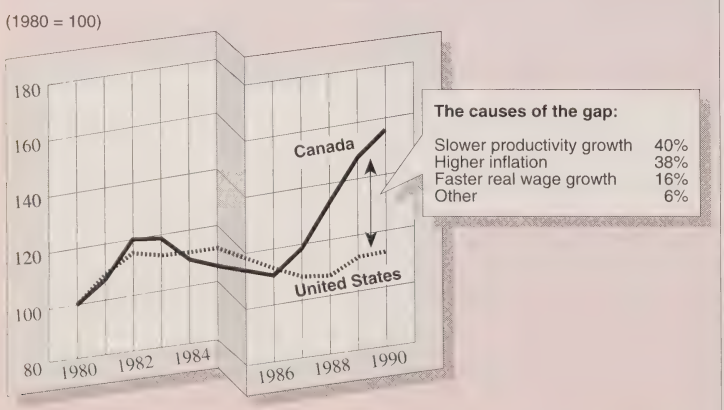
Conclusion

The Council's research suggests that the Canadian dollar has been significantly overvalued in recent years. The report points out, however, that an overvalued dollar can have positive effects by spurring improvements in productivity and reducing inflationary pressures. "Although we believe it is highly desirable for the external value of the Canadian dollar to move closer to its underlying economic fundamentals, there is no quick and costless way of achieving that goal," the report states.

While a lower exchange rate for the Canadian dollar would improve the position of Canadian manufacturing in the short run, the Council emphasizes that productivity growth and compensation settlements are the key issues over the medium to long term. Thus improvements in these two areas are "fundamental" to strengthening Canada's position internationally.

This does not mean that wages must be lowered. But wherever Canadian industry is at a cost disadvantage and wishes to retain its markets, it should seek productivity gains large enough to offset any existing wage differentials and any productivity improvements achieved by its competitors. The only alternative is to shift towards products that are not sold mainly on the basis of price on world markets.

Unit labour costs in manufacturing, Canada and the United States, 1980-90



Innovation: Canada lags behind

The links between technological innovation and economic performance are strong and complex.

For that reason, it is important to grasp the true dimensions of the innovation process from the outset. Technology is not a machine or an artifact. It is, first and foremost, a body of knowledge derived from many sources. As for the process of technological change, it encompasses a wide range of activities – from the introduction of a new product or a new method of production to the restructuring of a firm or the discovery of a new source of raw materials.

But in the area of innovation, whatever the factor considered, Canada lags behind its principal trading partners.

The use of advanced manufacturing technologies

The use of advanced manufacturing technologies such as computer-aided design and manufacturing through robotic assembly plants to automatic measuring devices, is an important characteristic of firms that emphasize innovation.

A 1989 survey on this subject carried out by Statistics Canada determined that, for all categories of technology, the size of the establishment concerned was the most important determinant of advanced technologies used. It appears that large establishments can more easily cope with the fixed costs, both financial and learning-based, associated with using high-tech equipment.

A Canada/U.S. comparison reveals that the use of these technologies in the five industry groups is greater in the United States than in Canada by some 5.5 percentage points. That is a sizeable gap.

Another finding of the Statistics Canada survey on the use of technologies was that about one half of Canadian establishments had experienced difficulty in finding highly skilled personnel. More than half of the problems in implementing CAD (computer-aided design) systems were linked to human and work organizational factors rather than technological problems.

A country's national commitment to R&D, especially on the part of its business sector, is the criterion most often used to infer its level of innovative activity. Canada has one of the lowest ratios (gross expenditure on research and development as a proportion of gross domestic product) among the 12 leading industrialized countries, being ranked just before Australia and Italy.

Given the importance of the resource-based manufacturing sector to the Canadian economy, one might expect that its industries would be relatively more research-intensive. That does not appear to be the case, however. The R&D propensity of these industries is only about 40 per cent of the average for the manufacturing sector as a whole. This situation contrasts with that in smaller countries like Sweden, which invest heavily in research in their key resource sectors. There is no commitment of this kind in Canada.

The quality and quantity of skilled workers, as well as the way in which they are organized and managed, have become fundamental factors in the process of successful innovation within individual firms. Given the rapid pace of technological change and the changing nature of the tasks required of workers, it is inevitable that the profiles of present-day jobs are substantially different from those of 20 years ago – as will be the jobs available 20 years hence.

The quality of the labour supply is thus of critical importance. Although the average number of years of schooling of the Canadian population is high (over 12 years), the secondary-school drop-out rate – about 33 per cent – reflects the weakness of the Canadian education systems. This situation contrasts sharply with that in Japan, where the drop-out rate is only 2 per cent, and with Germany, where it is under 10 per cent. One third of Canadian high-school graduates (about 1.2 million) cannot perform everyday reading requirements. And no fewer than 36 per cent of them experience difficulty in working with numbers.

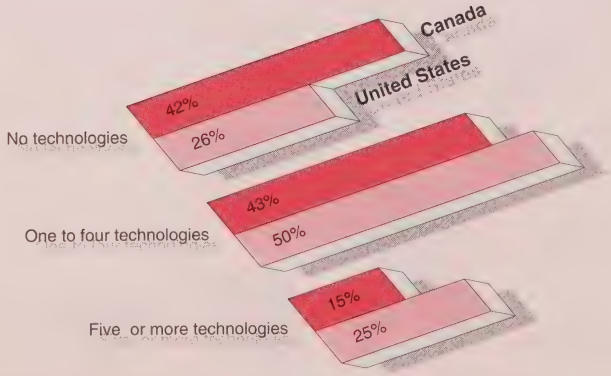
The proportion of scientists, engineers, and technicians in the labour force is also much lower in Canada than in the United States, Japan, and Germany.

Summary

Canada lags behind its major trading partners in the adoption and diffusion of new advanced technologies.

This situation suggests that Canadians – managers, workers, executives and students alike – are simply not reacting swiftly enough to the new demands of world markets. What is required to turn the situation around, therefore, is a change in attitude and behaviour on the part of all Canadians and a commitment to improve productivity.

Proportion of manufacturing plants using advanced technologies, Canada and the United States, 1989



Welcoming change

There is no magic potion that can cure the problem of weak productivity growth in Canada. And yet the problem requires urgent action, because it is the main reason that there has been little improvement in the real incomes of Canadians over the past two decades. Poor productivity also adversely affects the country's ability to successfully contest international markets.

As the Council emphasizes in its Statement, however, the picture is not entirely bleak. Canadians have one important advantage: they still command a head start over many industrialized nations. Canada remains near the front of the pack, but its lead is shrinking. Thus it is essential to act now.

Canadians must begin by learning to welcome change. This will require a fundamental shift in attitude and behaviour. It is all too clear that their slow reaction to changing economic conditions over the past several decades and their resistance to change have hampered the critical factor of productivity growth.

Besides learning to embrace change, Canadians must also learn to work together. For governments, that means better coordination of their actions and policy initiatives, which should be aimed at encouraging corporate productivity and innovation rather than bailing out foundering firms at any cost. The business community must show a greater willingness to cooperate and a more open attitude towards innovation, and it must pay more attention to worker training and skill development. Workers and labour unions, too, will have to do their share, particularly by seeking new formulas for job security and by placing greater emphasis on the acquisition of new skills.

Four basic messages

The Council sums up the main results of its research in the form of four closely interrelated messages. They are as follows.

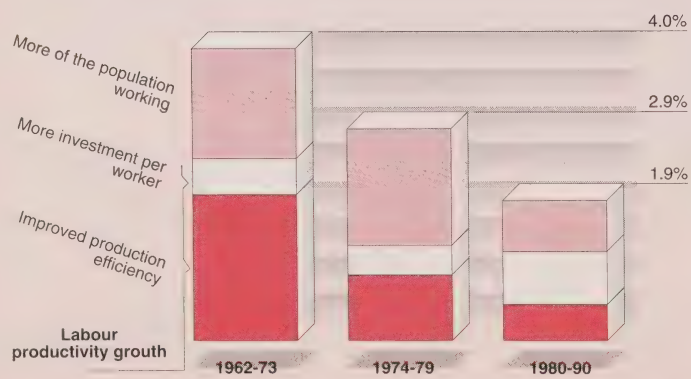
1. Canadians have not responded as quickly and effectively to changes in their economic environment as they need to in order to ensure steady growth in real incomes. From every point of view – productivity, innovation, and trade structure – the Canadian economy appears to be lacking in flexibility. There is considerable evidence of this slowness to adapt. For example, Canadian industries responded less effectively than the industries of many other industrialized nations to the energy price shocks of the 1970s; Canada's industrial structure has not been changing quickly enough; the commitment of Canadian business to training and organizational changes remains tepid; and, at the governmental level, there remain restrictions impeding the free flow of goods, services and labour between provinces.

2. Embracing change requires new attitudes in all segments of society. This means finding new ways of meeting challenges, including a more flexible approach on the part of business and labour to the rapidly changing economic context. According to the Council, an intensified effort is needed to enhance cooperation between all groups in society. And such efforts must be part of an on-going process, not just a surge of cooperation when times are tough. Canada also needs a national commitment to innovation, involving not simply new technology but also adaptations in workplace organization and on-going skill development.

3. Adjusting quickly and effectively to change requires government policies tailored to achieving better productivity performance. While it will not be a simple matter to reshape prevailing attitudes and behaviour, an appropriate public-policy framework can make the task easier. In terms of fiscal policy, the Council supports the federal government's present program of fiscal restraint. It encourages other levels of government to pursue a similar course. In light of the current debate on restructuring the economic union, the Council urges the players to ensure that fiscal decentralization does not compromise the competitiveness of Canadian industry. It also recommends that governments avoid bailing out firms through subsidies or import quotas when they have little prospect for longer-term efficiency.

4. Welcoming change entails a faster pace of adjustment, which will result in severe hardships for some people and some communities. Overcoming these hardships will require substantially increased investments in training, skill development, and mobility. Human-resource development policies must be considered the cornerstone of a strategy of national competitiveness. The Council believes that major changes to the basic structure of Canada's income-security system will be necessary, including a much stronger commitment to the reintegration of workers into productive employment.

Sources of growth in real income per person, Canada, 1962-90



The economic performance of immigrants

During the 1980s, more than a million immigrants reached Canadian soil. A long-standing subject of debate is the extent to which these new arrivals have had an impact on the Canadian economy and Canadian society. Views differ widely on this issue. Opinion is equally divided over the question of the economic performance of immigrants themselves.

Arnold deSilva, a senior economist with the Economic Council, recently attempted to throw some light on this second aspect of the question. In a study entitled *Earnings of Immigrants*, Mr. deSilva probed the economic performance of immigrants in order to determine how well they have adapted to the Canadian environment. On the basis of the latest available data (the 1986 census), the author concludes that the economic success of immigrants generally compares favourably with that of native-born Canadians.

Mr. deSilva's research was carried out as part of the project that produced the Council Statement *New Faces in the Crowd*, released last year by the Economic Council of Canada.

The changing face of immigration

Traditionally, immigrants to Canada tended to be from Europe and the United States. In the 1970s, however, the ethnic composition of the immigrant population began to shift perceptibly. Increasingly, immigrants hailed from other regions of the world – in particular, Asia, Africa, South America, Central America, and the West Indies. At the same time, the number of those coming from the more traditional sources of immigration declined. Thus many of the newest arrivals to Canada belong to "visible minority" groups.

Another important change in immigrant flows emerged in the mid-1970s: a shift from independent immigrants, who earlier constituted the majority, to family-class immigrants and refugees. Also noteworthy is the fact that immigrants, whether belonging to old or new groups, show a clear preference for large urban centres. Ontario receives the largest share of the immigrant population with 53 per cent, followed by British Columbia with



16 per cent, the Prairies with 15 per cent, and Quebec with 14 per cent.

In terms of educational attainment, the study reveals that the proportion of immigrants with university education tends to be higher than among the host population. On the other hand, the proportion of immigrants with only primary-school education is also higher than among the native-born.

Economic activity of immigrants

According to Mr. deSilva, economic statistics show that the labour-force participation rate of immigrants, corrected for age differences, is actually slightly higher than that of native-born Canadians (79.1 vs. 77.8 per cent), regardless of sex. The discrepancy is even greater when women only are considered.

Generally speaking, immigrants who have been established in the country for several years have lower unemployment rates than Canadian-born persons. The rates of new immigrants are however slightly higher than those of both earlier immigrants and the host population. Contrary to popular thinking, the proportion of recent immigrants on welfare assistance is extremely small. In fact, it is roughly similar to that of other Canadians.

The author explains that one would normally expect new immigrants to experience higher unemployment rates than those who have been in the country for some time, since all new arrivals must weather a "settling-in" period. Another reason for the higher unemployment rate of new immigrants may be the severity of the recession that occurred in the mid-1980s. The author suggests that immigrants are likely the first to lose their jobs in an economic slump.

Wage differences

Mr. deSilva also investigated the various factors that influence the wage gap between immigrants and native-born Canadians. Among these factors were the effects of education, proficiency in the country's official languages, and whether work experience was obtained in Canada or abroad.

The main conclusion that emerged from this analysis is that there is no significant discrimination against immigrants in general. More importantly, there is no general trend to discriminate against immigrants from the Third World – i.e., those belonging to visible minorities.

One exception occurs in the question of foreign versus Canadian education and experience. The author found strong indications that degrees earned abroad pay much less, in terms of wages, than those acquired in Canada. Research could not establish whether this phenomenon reflects bias or rather a genuine difference in the value of education and work experience. The end result is that it takes all but the youngest immigrants up to 20 years to catch up to the earnings of Canadians. Those Third-World immigrants who arrive young enough to obtain all of their education and experience in Canada earn the same wages as native-born Canadians.

In conclusion, the author finds that immigrants are adjusting reasonably well to the Canadian labour market.

Strengthening the economic union

A possible compromise

In a recent speech to the Chambre de commerce et d'industrie du Québec métropolitain, Judith Maxwell, the Chairman of the Economic Council, summarized the main points of the Council's most recent Annual Review and put forward some elements of a possible compromise aimed at protecting and strengthening the Canadian economic union. A report on Mrs. Maxwell's address follows.

It is possible to reach a compromise that meets the aspirations of Quebecers while still preserving the Canadian economic union upon which the continued well-being of all Canadians depends.

That was the main message delivered by Mrs. Maxwell who also warned Canadians of the negative economic consequences of disrupting fiscal ties and of an excessive decentralization of powers. The risk is that all Canadians will be left the poorer, especially those in the smaller provinces – and also in Quebec.

She pointed out that decentralization would make it extremely difficult to maintain the free movement of goods and services, people and capital across provinces. Thus decentralization does not diminish the need for federal/provincial coordination; it increases it.

A possible compromise

Expressing her personal views, Mrs. Maxwell sketched out the main points around which a new compromise might be forged that would meet the aspirations of Quebecers without penalizing other regions of the country.

Such a compromise, aimed at protecting and strengthening the economic union, should include the following four elements:

1. Some decentralization of program areas that are most sensibly managed at the provincial level (such as housing and tourism), as well as greater use of concurrent powers in areas where both levels of government have a strong interest, including communications and the environment.
2. Enrichment of the equalization formula in order to minimize disparities in tax rates and services (the extent depending on the degree of decentralization involved).
3. Some increase in the asymmetric arrangements that already exist for Quebec and other provinces. In the case of Quebec, this could be in areas relevant to the province's unique character, including cultural policy and manpower training.
4. A commitment to improve the way the economic union is managed, involving two elements in particular: a) a constitutional commitment to the free movement of goods, services, capital and people across provincial borders; and b) a political commitment to establish a "council of the federation" to monitor moves to reduce and dismantle interprovincial barriers and to harmonize decisions on other policies affecting the economic union.

According to Mrs. Maxwell, the compromise outlined above would have the advantage of protecting the economic union while giving Quebec the room it needs to implement its priorities. She noted some examples of innovative approaches to economic strategy recently proposed by two ministers in the Quebec government – Gérald Tremblay's "industrial clusters" and André Bourbeau's new approach to manpower policy.

These examples show that the current Constitution offers Quebec considerable scope to adopt its own economic strategy without intervention from the outside. But it is important for Quebec to choose policies that are outward looking and compatible with policies being pursued in Ottawa and other provinces because the provincial economies are connected to each other by strong economic and fiscal linkages. What happens in the central provinces – Ontario and Quebec – has a big impact on the others.

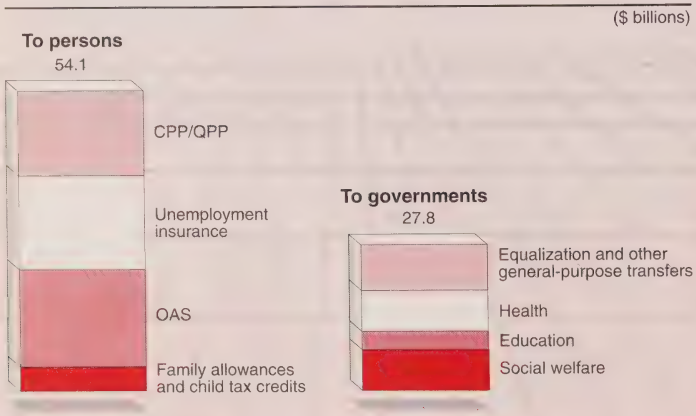
Economic linkages

The commercial ties binding the various regions of the country include trade, investment and migration.

About 58 per cent of Quebec's exports of goods and services are sold to the rest of Canada, including one third to Ontario, 10 per cent to the Atlantic provinces, and 15 per cent to western Canada. Quebec firms earn 22 per cent of their revenues from operations in other provinces. External investors (Canadian and foreign) account for some 31 per cent of all corporate revenues earned in the province.

When it comes to labour mobility, it is interesting to note that francophone Quebecers tend to be less mobile than other Canadians. Fewer than 1 per cent leave the province over a typical five-year period. This compares with an average of 3.6 per cent for the country as a whole.

Federal risk-sharing transfers, 1990-91



These statistical differences reflect underlying cultural and linguistic differences and have important economic consequences. They help to explain why asymmetric arrangements have worked satisfactorily in Quebec, as in the case of pensions and tax collection. However, there are limits on Quebec's ability to be different.

The economic linkages in Canada for goods, services, capital, and people are impressive. They are responsible for about 465,000 jobs in Quebec and 2 million in the rest of Canada.

"At a time when we are struggling to create jobs for Canadians in a climate of tough world competition, we certainly cannot afford to disrupt these linkages," Mrs. Maxwell stated.

Risk-sharing

The capacity of the provinces to finance public services varies considerably because of differences in fiscal capacity. For example, the fiscal capacity of Quebec has averaged about 86 per cent of the national average in the past three years. The express purpose of the equalization payments made by the federal government is to help the provinces to provide similar public services at comparable tax rates.

Yet even more sharing is going on between provinces, through the implicit equalization built into federal programs. Not many Canadians understand this sharing. For example, Ontario employers and employees pay $2 billion a year more into the unemployment insurance fund than Ontario workers take out. In effect, they are subsidizing employers and employees in other provinces who take more out of the system than they put in.

What this means, says Mrs. Maxwell, is that any move towards decentralization involving an across-the-board reduction in federal taxes will leave Quebec and the other provinces with low fiscal capacity with the choice between big tax increases or drastic cuts in spending.

Under the decentralization scenario proposed by the Allaire report, the provinces would assume full responsibility for transfers to individuals and business and for health, education, and social welfare. In this case Quebecers would face a tax increase of 1.7 % or about $3.5 billion. The situation would be even more serious for small provinces like Newfoundland, where taxes would rise by the equivalent of 16 per cent of GDP.

Such an extensive decentralization would also have negative repercussions for the economic union. With widely varying tax rates across provinces, investors and social-assistance recipients would tend to move to other provinces, the former to low-tax jurisdictions and the latter to high-benefit jurisdictions. "The net result would be a tendency to impoverish poor provinces and to create congestion in the rich ones."

Mrs. Maxwell concludes that large disparities in tax rates lead to inefficiencies that make all Canadians a little poorer.

Conclusion

While economists can inform the current debate on the future of the federation, the fundamental choices remain political.

"Canada is an economic union – an organic whole. There is no way that a fabric this tightly knit can be ripped apart without a severe economic shock."

No one knows with certainty what the cost of a break-up would be – but it would be high. "We should therefore concentrate our energy on renewing and strengthening what we have – an economic union and a system for sharing

Additional revenues required under extensive decentralization, 1994-95

	Per cent of GDP	$ billions	$ per capita
Newfoundland	*16.2*	*1.7*	*2,984*
Prince Edward Island	*12.4*	*0.3*	*2,266*
Nova Scotia	*3.2*	*0.5*	*702*
New Brunswick	*6.6*	*1.4*	*1,489*
Quebec	*1.7*	*3.4*	*479*
Ontario	*–2.6*	*–9.7*	*–917*
Manitoba	*1.4*	*0.4*	*379*
Saskatchewan	*3.1*	*0.8*	*763*
Alberta	*–0.8*	*–0.7*	*–270*
British Columbia	*1.8*	*1.9*	*–551*

Free trade: Canada, the United States, and Mexico

Mexico!

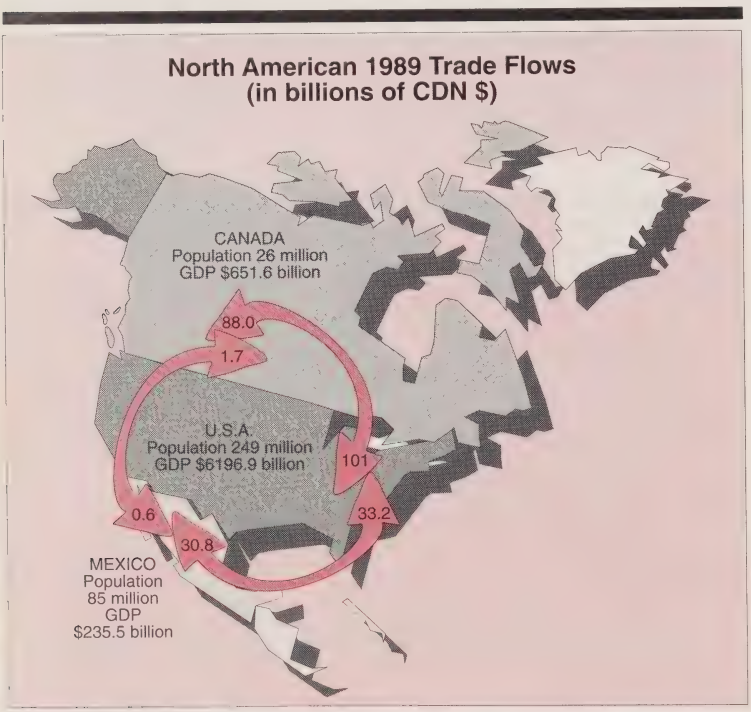
For many Canadians, the mere mention of that country's name evokes images of sun-splashed beaches, siestas under the palms, and vacation hideaways perfect for melting memories of northern winters.

For many workers and businessmen, however, quite a different image comes to mind. For them, far from a holiday mecca, Mexico is a dark and ominous threat looming on the horizon. They are worried about what will happen should Canada enter into a trilateral free-trade agreement involving Mexico, the United States and Canada.

What they fear is that Mexico's vast pool of low-cost labour will provide unfair competition for Canada if Mexico is integrated into the North American economy. The result could be a flow of jobs and capital away from Canada and towards Mexico.

In a recent speech to the Canadian Economics Association, Sunder Magun, a senior economist and project director at the Economic Council explored various aspects of this thorny question. While he identified some of the potential trouble spots for Canada, he nevertheless concluded that a positive outcome to these three-way negotiations will mean substantial long-term benefits for Canada.

Addressing the subject of Canadian reluctance to participate in the trilateral free-trade talks, Mr. Magun noted Canada's concern that a bilateral agreement between Mexico and the United States would end up diverting to Mexico some of the U.S. imports that are now purchased from Canada. Furthermore, the expected gains from the free-trade agreement previously concluded between Canada and the United States might not materialize if the United States and Mexico sign a bilateral agreement. Canadian companies that depend on exports to the U.S. market might also be tempted to pack up and move to Mexico in order to benefit from lower wages in that country.



Overall, then, Canada's motivation for participating in trilateral negotiations stems at least partly from a desire on the part of the Canadian authorities to minimize the negative effects of possible export and investment diversion to Mexico.

Overview of the situation

Direct trade linkages between Canada and Mexico are very limited, but they are growing.

In 1987, Canada exported $418 million (US) worth of goods to Mexico and imported $882 million (US) from there. Canada's trade with Mexico accounted for 0.4 per cent of total exports while the comparative figure for Mexico was 2.3 and 2.6 per cent.

The United States is the largest trading partner of both Canada and Mexico. And, notes Mr. Magun, the U.S. market is gaining in importance for both of these countries as well: about 75 per cent of Canadian and Mexican exports are now destined for the United States.

The pattern of trade between Canada and Mexico, however, is quite distinctive In 1987, for example, about two thirds of Canadian exports to Mexico were either agricultural products or resource-intensive commodities. The remaining one third fell into the machinery and transportation equipment group.

The structure of Mexican exports to Canada has changed considerably over the years. Close to 70 per cent now belong to the machinery and transportation equipment group. It is significant, however, that the production of most of these products requires primarily low-skill labour. The same group of products accounts for a large share of Mexico-U.S trade. This trading pattern results largely from the intra-industry trade of large multinational enterprises.

Areas of specialization

Each country in the North American market has its own set of comparative advantages when it comes to trading with its neighbours.

Generally speaking, Mexico's comparative advantages are significantly different from those of Canada. They lie

mainly in industries that require extensive amounts of low-skill labour. Such industries are found mainly in the large assembly complexes commonly referred to as "maquiladoras." Their products include telecommunications equipment, sound-recording equipment, and automotive parts. The sophisticated nature of some of the equipment manufactured can be misleading, however: for the most part, these factories are elementary, in the sense that they are concerned mainly with product assembling. Most of these complexes are located close to the U.S. border in order to benefit from the Mexican economy's lower wage rates.

However, Mexico can be expected to increase its automotive parts production capacity significantly. The Mexican auto industry may eventually pose a sizable challenge to its Canadian counterpart.

According to Mr. Magun, in the event of economic integration, each country will capitalize on its respective comparative advantages. In other words, each will attempt to build its exporting capabilities by doing better what it already does well.

Nevertheless, an analysis of trading patterns in 1987 reveals that almost one third of Canadian exports were matched by equivalent Mexican exports in the same product categories.

In fact, the similarity index between the two countries climbed from 16 per cent to 34 per cent between 1971 and 1987. This indicates, says Mr. Magun, that Mexico's economic structure is becoming more similar to Canada's. Consequently, Canada could face even more competitive pressure following trade liberalization and would probably lose some market share within the United States. Canada would certainly have to adjust to the new trading environment, incurring significant transition costs.

Even in the domestic market, Canadian industries would have to contend with cheaper Mexican imports, particularly in such industries as textiles, rubber and plastic products, and leather products. And this would come on the heals of the stiffer competition that these same industries now face from the newly industrialized countries of Asia and from Third World nations.

Advantages

But freer trade with Mexico does not simply entail disadvantages. According to Mr. Magun, the economic advantages associated with North American economic integration largely outweigh the potential losses.

First and foremost, Canada would enjoy direct export gains.

Canada's exports to Mexico are currently very small. Under a trilateral free-trade agreement, there would be an enormous potential for increasing exports and foreign investment in Mexico. The expanding Mexican economy, coupled with a population expected to climb to 100 million by the end of the decade, will generate a strong demand for imported products and services. This could represent a golden opportunity for Canadian businesses.

Mr. Magun admits that the economic gains flowing from a trilateral free-trade agreement have not yet been quantified. Further research is needed to draw a clearer picture of the situation.

Forthcoming publications of the Economic Council

Annual Report, 1991-92

Statements

A Lot to Learn: Education and Training in Canada

The New Face of Poverty: Income Security Needs of Canadian Families

Studies

Controlling Drug Expenditures in Canada: The Ontario Experience, by Paul K. Gorecki

Regional Welfare Impacts of Some Alternative Fiscal Arrangements, by Andrew Burns

Exchange Rates and the International Competitiveness of the Canadian Economy, by Richard G. Harris

Working papers

"An Assessment of the Properties of the Meidum-Term Forecasting Model of the Conference Board of Canada," by *Richard Roy* and *Gilles Bérubé*

"Tradeable-Rights Approach to Environmental Policy: Some Accounting Problems of Application," by *H. H. Postner*

"An Exploratory Analysis of Canada's International Transactions in Service Commodities," by *James J. McRae*

"Traps and Vicious Circles: A Longitudinal Analysis of Participation in the Canadian Unemployment Insurance Program," by *Miles Corak*

"Issues for Women in Canadian Education," by *J. Gaskell*

"The Funding of Postsecondary Education in Canada," by *Tim Sale*

"The Financing of Elementary and Secondary Education in Canada," by *Tim Sale*

Guaranteed annual income vs. work habit

Fears that are misplaced

Fear that some of Canada's social programs really discourage people from working is actually misplaced.

For some time now, the policy debate about the reform of welfare and poverty-relief programs, particularly income support based on a guaranteed annual income, has focused on a central question: how is the work behaviour of those receiving assistance affected? The political acceptability and economic feasibility of a guaranteed-annual-income scheme have always been extremely controversial subjects. According to conventional economic theory, in fact, giving able-bodied persons a guaranteed annual income without strings attached may prompt them to work less.

A recent study prepared for the Economic Council of Canada disputes these beliefs. Entitled *Income Maintenance, Work Effort, and the Canadian Mincome Experiment*, the study is the work of two researchers from the University of Manitoba, Derek Hum and Wayne Simpson.

The two economists believe that the impact of tax transfers via a guaranteed-annual-income plan (or a negative income tax) on the incentive of recipients to look for work is small enough that it should not be considered the determining factor.

The authors acknowledge that their conclusions are guarded but they view them as reassuring nevertheless, because they support the idea that a guaranteed-income plan can be used as a tool for eliminating poverty.

The Mincome project

Poverty in Canada is an enduring social issue. Back in 1968, the Economic Council of Canada reported that poverty among Canadians was much more widespread than generally believed.

The public's desire to see the income-support system reformed, notably through the introduction of a guaranteed annual income, led to extensive research and social experiments designed to assess the effects of such a program.

It was in this climate that the Mincome project, jointly administered and financed by the federal government and the government of Manitoba, was launched in 1975. One of the main aims of the project was to answer questions about the effects of a guaranteed annual income on the incentive to work. However, the program died in the late 1970s and the data that had been gathered lay untouched by researchers for many years.

This body of data was the focus of researchers Hum and Simpson as they addressed the controversial question of the relationship between income support and work incentive. Another part of their research involved an exhaustive review of the main studies of labour supply carried out in Canada and the United States to date.

The Mincome project has been termed one of the most important social experiments in Canadian history. It cost over $17 million at the time and over a period of three years, made payments to more than a thousand Manitoba families.

Mincome's design involved selecting participants randomly and assigning them to different negative-income-tax programs or to a control group. The participants assigned to the program received monthly income payments tied to their family revenues for three years.

Analysis of the results revealed that hours worked fell between 0.8 and 1.6 per cent among men, between 2.4 and 3 per cent among married women, and between 3.8 and 5.3 per cent among single women.

The two economists also discovered that the existence of preschool children in the home increased labour supply for married men, but reduced it for married women.

The authors acknowledge that precise measurements of the effects of income-support programs on the incentive to work are very difficult and that economists have yet to master this skill. However, they believe that their analysis of the data indicates that changes in the tax-transfer system appear to have little impact on individuals and families.

As for the Mincome experiment, Hum and Simpson argue that it should not be judged on its failure to produce a guaranteed-income plan, but rather on the basis of its legacy of data and research opportunities.



Competitiveness and the public sector

What impact does government activity have on Canadian competitiveness? A complex question, to be sure. Government activity is omnipresent, affecting the lives of all Canadians. In addition to providing a wide range of services, governments establish the regulatory framework for many sectors of the economy and (of course) collect taxes. But how effectively are these tasks accomplished? Could Canada's overall competitiveness be better served? In fact, what does competitiveness really mean in this context? At the express request of the Prime Minister, the Economic Council has begun an ambitious research project to study the impact of the public sector on competitiveness. To find out more on this major undertaking, *Au Courant* interviewed Bryne Purchase, a Senior Research Director at the Economic Council, and the director for this study.

Au Courant: What is the overall mandate of your study?

Purchase: The Prime Minister's letter directs us to study the relationship of government, at all levels, to international competitiveness. That is an enormous mandate, by anyone's standard. Indeed, our major problem has been to develop an organizing framework for such an ambitious project. But we have set three basic objectives.

Our first objective is to study the institution of government. What is its role in modern society? What advantages and disadvantages does it have in carrying out its assigned roles compared with other institutions? Is it efficient, adaptive and innovative? Is it subject to serious diseconomies of scale? Have these changed over time? In short, we are working towards a more formalized micro-economic model of public sector supply.

Secondly, we want to delineate and to examine the relationships of the institutions of government to other institutions in society, for example, the corporation and the household. Our particular purpose is to determine how government impacts on the competitiveness of these other social institutions. Since there are many possible linkages, we want to focus on only those with the greatest effect, or most significance, in the overall activities of government and the economy.

The third objective is not really a research objective, but it is an important program objective. We want to help inform a broader public, through an open research and seminar process, about the issues confronting public sector decisions and the relationship of those choices to the competitiveness of our society.

Au Courant: The word "competitiveness" is used a lot. Does it have a special meaning in your project?

Purchase: Strangely enough, most economists are not comfortable with the term competitiveness. In my view this is because many of the models they use to think about competitiveness are devoid of institutions, other than markets. Yet competitiveness is fundamentally an institutional concept.

But before I turn to that, let me say that we use a now widely accepted measure of competitiveness – one that has been used by a number of projects, including Michael Porter's study and, most recently by the Economic Council in *Pulling Together*. In these studies, a country's international competitiveness is measured by both the level and growth in total factor productivity (TFP) relative to other trading nations. TFP is a measure of the overall efficiency of the economy and the growth in that efficiency over time. It captures the joint productivities of all institutions and all factors, even if the productivities are not accurately assigned in the national accounts ... for example, government is assumed to have zero productivity growth in the national accounts. The key elements in the growth of these national efficiencies are quick imitation of superior technique or technology found elsewhere and the capacity to innovate.

One other thing, TFP growth is linked to growth in real income per capita. Indeed, the Council's research shows that 75 per cent of the decline in the growth of real income per capita since 1973 has been the result of the slowdown in TFP growth.

"Strangely enough most economists are not comfortable with the term competitiveness."



Bryne Purchase

Au Courant: What have institutions got to do with this measure of national competitiveness?

Purchase: While TFP is an appropriate measure of competitiveness, it is not a description of what is meant by the term "competitiveness." As I said, competitiveness is an institutional concept: an institution is competitive if it is efficient in meeting its goals; if it is adaptive in terms of its quick imitation of superior techniques used elsewhere; and if it is innovative in its own right. It is these three institutional qualities –

efficiency, adaptability and innovativeness – that we use to define the meaning of competitiveness.

Au Courant: How does this relate to the public sector?

Purchase: When competitiveness is defined in those institutional terms, it is equally applicable to both public and private institutions. This is an important point. All institutions are capable of being competitive in the terms described above. The issue then becomes: What induces them to be so? And how does the competitiveness of one set of institutions relate to the competitiveness of others? And what makes the total "cluster" of public and private institutions competitive?

Au Courant: What are the factors that induce competitiveness?

Purchase: The two elements that we are focusing on now are the governance structure of the institution and the degree of external pressure – for example, from direct competition or other demanding external relationships. By governance, we mean the way in which the institution is internally structured to ensure accountability for performance, and the nature of that accountability. Insofar as external pressure is concerned, our focus is on competition. We know that price competition can, under certain conditions, lead to economic efficiency. We presume that competition is equally important to adaptation and innovation.

Au Courant: What are the linkages from government to the private sector?

Purchase: The linkages that we have identified in respect of government, corporations and households, focus on four areas:

The first is in respect of the provision of key public infrastructure to the business community such as the legal framework, capital infrastructure and access to natural resources.

The second area that we have identified is the regulatory activities of government. We break this into two types. Regulation of markets for factors such as labour, environment and finance is one area of study. One might call these social regulations. The second area of study is economic regulation – governing the price of certain goods or services, product standards and the degree of competition in product markets.

The third linkage between the government sector and households is the provision of social infrastructure. This is, by far, the most dominant part of government spending. It accounts for about 60 per cent of all spending, not including costs of debt service, which are about 20 per cent. There are the obvious "public goods" related to the security of persons and properties, such as fire and police protection and defence. However, the disproportionate amount of government spending – about 50 per cent of the total – is on the provision of education; health; insurance (such as unemployment insurance, health insurance, workers' compensation, deposit insurance); the provision of pensions, such as CPP, QPP and OAS; the provision of welfare; and the provision of housing. It is in this area that the most dramatic growth of government has taken place in the postwar era.

> ***"In the final analysis, the competitiveness of a society is doubtless a reflection of the competitiveness of each of the institutions of which it is comprised."***

The final link of government to the competitiveness of the economy is through its international negotiations covering such things as trade, investment, product standards, environmental standards, tax and finance.

These are the key linkages and each of them represents some part of the work we will be undertaking.

Au Courant: Have studies of this nature ever been done elsewhere? If so, how do they relate to your particular research?

Purchase: There is a considerable amount of research that has focused recently on the international aspects of competitiveness related to the negotiation of treaties on trade, taxes, investment flows, and increasingly, with respect to environmental agreements.

There is, as well, a very substantial amount of research on the services that government provides to business in the form of protection for intellectual property, bankruptcy laws, and research and development incentives, as well as on the key role that these services can play in corporate competitiveness.

Indeed, because of the amount of research that has been devoted to these areas, we are more focused in our program on the areas that have not received as much emphasis recently, that is to say, social regulation and the efficient provision of both economic and social infrastructures.

Au Courant: What about specific industries? Will you be looking, for example, into the resource industry?

Purchase: Yes, resource industries dominate our export sector. They are the industries in which we are most successful in international markets, as measured by our share of those markets. Obviously, we are interested in their linkages to government. Typically, resource industries are intense users of both environmental and natural resources. In the 1980s, one of the key issues for the resource sector was that of politically secure access to the U.S. market. At the heart of this issue of secure access have been questions with respect to how natural resources are

priced by governments. The same type of issues can arise in respect of environmental regulation. Both issues fit into our program in respect of the efficient provision of economic infrastructure.

Au Courant: What other types of economic infrastructure issues are you dealing with?

Purchase: We want to take a close look at the decision processes surrounding capital spending in the public sector. It has been alleged that the public sector underinvests in capital infrastructure. We want to test that proposition theoretically as well as empirically.

Au Courant: You mentioned regulations. How do they fit into your research?

Purchase: There are three basic research questions for us. The first is to investigate the process by which a regulatory standard is chosen. How do we measure costs and benefits? Whose views are considered? Who is accountable for the standard that is chosen? How does one minimize rent seeking? The second set of issues concerns the efficient implementation of a standard, once it has been decided. Do we let individuals and firms make efficient choices, depending on their circumstances? Can we use incentives to achieve social objectives? Or should we direct them centrally as to their actions? The third set encompasses the question of the social efficiency of regulation. Do stringent regulations enhance productivity performance? These are the basic questions, but the answers are not as easy to lay out.

Au Courant: What about social infrastructure? As you note, it accounts for the largest part of government outlays. What are the issues?

Purchase: Similar types of questions arise as in the investigation of economic infrastructure. Do we over or underinvest in these services? If so, why? Are the services delivered efficiently? Are they priced efficiently? What is the governance structure of some of the key public-sector suppliers (for example, hospitals or schools)? Who is accountable to whom and for what? Is there any competition? Is there a role for competition? If so, from whom? How can competition be introduced?

Au Courant: Is public sector wage determination an issue in efficient supply?

Purchase: Yes it is. Wages are the largest component of social infrastructure spending. How these are determined is central to the cost effectiveness of public suppliers. We intend to take a look at these issues. Physicians, on the other hand, are private suppliers with a fee negotiation with government. We want to look at that option as well.

Au Courant: Is there a link between economic infrastructure and social infrastructure?

Purchase: In a budgetary sense there is certainly a trade-off if the total budget is constrained. That is an issue for us. How do governments make the choice? What is the relationship between social infrastructure and the growth of TFP. One important link is the impact of taxes on productivity when the revenue is used for social spending that involves large redistributions of income. We know the tax impact is negative. What we do not know, or have not measured, are the benefits of economic security and redistribution, if any, in terms of TFP growth.

Au Courant: Are there other important aspects of your research agenda?

Purchase: The study of the competitiveness of government, as that term is defined here, requires looking at its governance structure, the policy processes of government – the ways in which it is held accountable and for what it is held accountable. It requires, as well, a review of the mechanisms of competition between governments, either domestic or foreign, and of the propensity for that competition to be positive or negative.

Au Courant: Any final comments?

Purchase: In the final analysis, the competitiveness of a society is doubtless a reflection of the competitiveness of each of the institutions of which it is comprised. But the total is likely to be greater or lesser than the sum of its parts. Michael Porter notes this when he discusses "clusters" of private corporations, with positive feedback mechanisms at work.

What we are looking for is a dynamic positive feedback situation between public and private institution – a situation of increasing returns to scale. This has been studied by Brian Arthur in respect of the social choice between technologies. Richard Lipsey and others are also looking at these issues in the context of private corporations and productivity growth.

That is why the relationships between institutions are important. There can be a partnership, even when the relationship is essentially competitive. The potentially divergent paths of nations forward to ever greater successes, or in the long spiral downward, is one which may be conditioned by these relationships.

"We want to take a close look at the decision processes surrounding capital spending in the public sector."

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PUBLICATIONS

Council report

Pulling Together – Productivity, Innovation, and Trade (EC22-180/1992E; $8.25 in Canada; US$9.90 outside Canada).

This new Council Statement looks at Canada's ability to maintain and improve its current high standard of living. Canadians are now increasingly concerned about their economic future. They feel that the foundations of their economic prosperity have been shifting and their economic future is now less secure than it once was.
The Economic Council examines why Canada is facing economic uncertainties and what can be done about them. The Statement looks at the structural changes that are going on in the world economy and at the reactions of Canadians to these global changes.

Studies

Earnings of Immigrants: A Comparative Analysis, by Arnold deSilva (EC22-179/1992E; $8.25 in Canada; US$9.90 outside Canada).

A crucial issue in the debate over immigration is the impact it has on the welfare of the host country. One aspect relevant to this question is how new immigrants adjust to the Canadian labour market. This new study analyses the economic performance of immigrants by examining income differentials. Using regression analysis, it attempts to isolate the main factors that are likely to explain the wages received by first-generation immigrants and Canadian-born persons.

The Constitutional Division of Powers – An Economic Perspective, by Robin Boadway (EC22-178/1992E; $10.95 in Canada; US$13.15 outside Canada).

In his study, Professor Boadway analyses the economic rationales for the allocation of responsibilities among levels of government in a federal system. Efficiency and equity considerations are used as yardsticks for evaluating alternative allocations of powers.
The study also reviews the evolution in Canada of the relative importance of federal and provincial activity in the area of taxation and spending over the last 30 years, noting the steady rise in the importance of the provinces over that time.
The paper concludes with an examination of some of the financial consequences of three different kinds of possible constitutional reform; one-way symmetric decentralization; two-way reallocation of responsabilities; and asymmetric decentralization to Quebec alone.

Working papers

No. 22 "The Interdependence of Industrial Activites," by *T. Siedule.*

No. 23 "Goods and Service Sectors Structural Change and Canadian Economic Growth: 1967-86," by *D.C.A. Curtis* and *K.S.R. Murthy.*

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